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# On the Radar
## Current Expected Credit Losses

The approach used to recognize impairment losses on financial assets has long been identified as a major weakness in current U.S. GAAP, resulting in delayed recognition of such losses and leading to increased scrutiny. Accordingly, the FASB issued ASU 2016-13 to amend its guidance on the impairment of financial instruments. The ASU adds to U.S. GAAP an impairment model known as the current expected credit loss (CECL) model, which is based on expected losses rather than incurred losses. The objectives of the CECL model are to:

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

**Guidance Applies to More Than Just Banks**

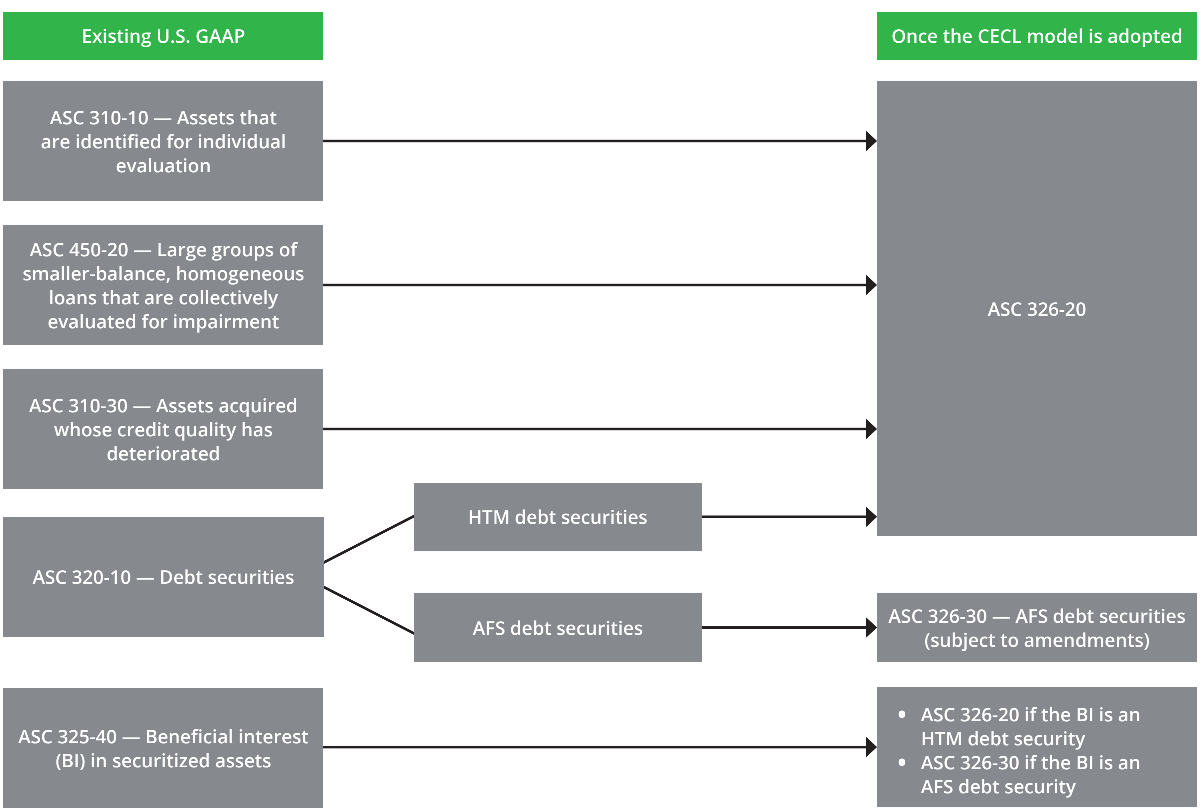
The new guidance will significantly change the accounting for credit impairment. Although the new CECL standard has a greater impact on banks, most nonbanks have financial instruments or other assets (e.g., trade receivables, contract assets, lease receivables, financial guarantees, loans and loan commitments, and held-to-maturity [HTM] debt securities) that are subject to the CECL model. While banks and other financial institutions (e.g., credit unions and certain asset portfolio companies) have been closely following standard-setting activities related to the new CECL standard, are actively engaged in discussions with the FASB and the transition resource group (TDR), and are far along in the implementation process, many nonbanks may not have started evaluating the effect of the CECL model. Nonbanks that have yet to adopt the guidance should (1) focus on identifying which financial instruments and other assets are subject to the CECL model and (2) evaluate whether they need to make changes to existing credit impairment models to comply with the new standard.

## Reduction in Impairment Models

The FASB set out to establish a one-size-fits-all model for measuring expected credit losses on financial assets that have contractual cash flows. Ultimately, however, the FASB determined that the CECL model would not apply to available-for-sale (AFS) debt securities, which will continue to be assessed for impairment under ASC 320.

**No impairment model is needed for financial assets measured at fair value (e.g., trading securities or other assets measured at fair value by using the fair value option) because the assets are measured at fair value in every reporting period.**

The diagram below depicts the impairment models in current U.S. GAAP that are being replaced by the CECL model.



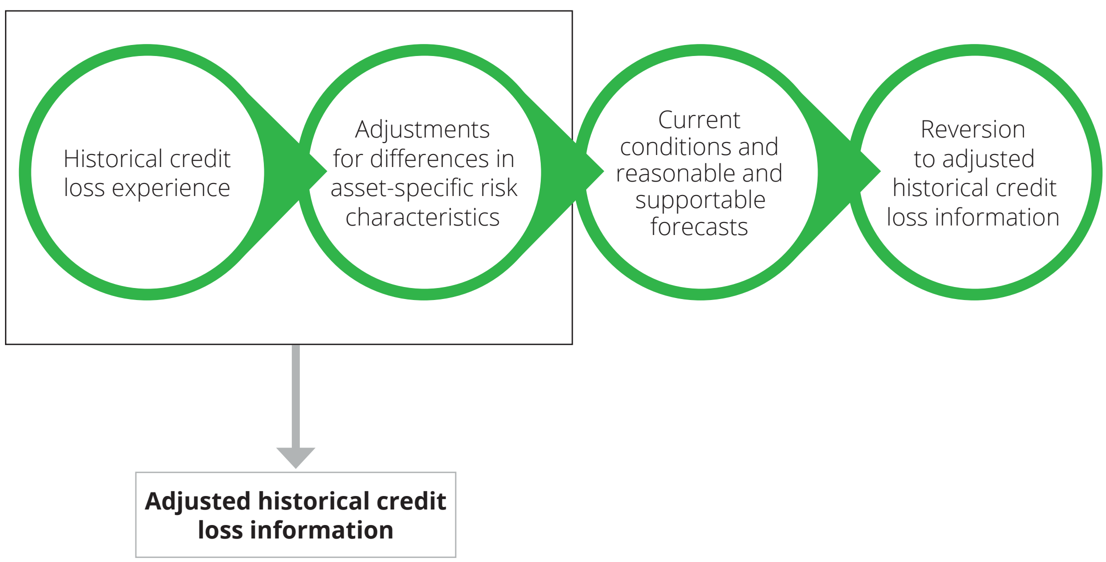
Although the FASB was not able to develop a single impairment model for all financial assets, it did achieve its objective of reducing the number of impairment models in U.S. GAAP.

## Expected Losses Versus Incurred Losses

Unlike the incurred loss models in existing U.S. GAAP, the CECL model does not specify a threshold for recognizing an impairment allowance. Rather, an entity will recognize its estimate of expected credit losses for financial assets as of the end of the reporting period. Credit impairment will be recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset.

## Estimates Represent Lifetime Losses

An entity's estimate of expected credit losses should reflect the losses that occur over the contractual life of the financial asset. When determining the contractual life of a financial asset, an entity is required to consider expected prepayments either as a separate input in the method used to estimate expected credit losses or as an amount embedded in the credit loss experience that it uses to estimate such losses. The entity is not allowed to consider expected extensions of the contractual life unless (1) extensions are a contractual right of the borrower or (2) the entity has a reasonable expectation as of the reporting date that it will execute a TDR with the borrower.[1]




An entity must consider all available relevant information when estimating expected credit losses, including details about past events, current conditions, and reasonable and supportable forecasts and their implications with respect to expected credit losses. That is, while the entity can use historical charge-off rates as a starting point for determining expected credit losses, it has to evaluate how conditions that existed during the historical charge-off period may differ from its current expectations and accordingly revise its estimate of expected credit losses. However, the entity is not required to forecast conditions over the contractual life of the asset. Rather, for the period beyond the period for which the entity can make reasonable and supportable forecasts, the entity reverts to historical credit loss experience.

[1] ASU 2022-02, issued on March 31, 2022, eliminates the concept of a TDR from a creditor's accounting. As a result, an entity that has adopted ASU 2022-02 will no longer be able to extend the contractual term for expected extensions, renewals, and modifications when it reasonably expects, as of the reporting date, that a TDR will be executed with the borrower.

## No Prescribed Method

The FASB believes that the impairment allowance should reflect *management's* expectations regarding the net amounts expected to be collected on a financial asset and that, because entities manage credit risk differently, they should have flexibility when reporting those expectations. As a result, the FASB did not require entities to use a specific method when measuring their estimate of expected credit losses. Accordingly, an entity can select from a number of measurement approaches to determine the allowance for expected credit losses. Some approaches project future principal and interest cash flows (i.e., a discounted cash flow [DCF] method), while others project only future principal losses. ASU 2016-13 emphasizes that an entity should use methods that are "practical and relevant" given the specific facts and circumstances and that "[t]he method(s) used to estimate expected credit losses may vary on the basis of the type of financial asset, the entity's ability to predict the timing of cash flows, and the information available to the entity."

**Although the method used to measure expected credit losses may vary for different types of financial assets, the method used for a particular financial asset should be consistently applied to similar financial assets.**

The table below summarizes various measurement approaches that an entity could use to estimate expected credit losses under ASU 2016-13.

| Measurement Approach | High-Level Description |
|---|---|
| DCF method | Expected credit losses are determined by comparing the asset's amortized cost with the present value of the estimated future principal and interest cash flows. |
| Loss-rate method | Expected credit losses are determined by applying an estimated loss rate to the asset's amortized cost basis. |
| Roll-rate method | Expected credit losses are determined by using historical trends in credit quality indicators (e.g., delinquency, risk ratings). |
| Probability-of-default method | Expected credit losses are determined by multiplying the probability of default (i.e., the probability the asset will default within the given time frame) by the loss given default (the percentage of the asset not expected to be collected because of default). |
| Aging schedule | Expected credit losses are determined on the basis of how long a receivable has been outstanding (e.g., under 30 days, 31–60 days). This method is commonly used to estimate the allowance for bad debts on trade receivables. |

## Looking Ahead

Although the FASB has issued several ASUs that amend certain aspects of ASU 2016-13, the Board continues to seek feedback on the new guidance. As a result of that feedback, on March 31, 2022, the FASB issued ASU 2022-02, which eliminates the accounting guidance on TDRs for creditors in ASC 310-40 and amends the guidance on "vintage disclosures" to require disclosure of current-period gross write-offs by year of origination. For entities that have already adopted ASU 2016-13, the amendments in ASU 2022-02 are effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For entities that have not yet adopted ASU 2016-13, the amendments in ASU 2022-02 are effective upon adoption of ASU 2016-13. Early adoption is permitted in certain circumstances.

In addition, the FASB continued making progress on its project on the PCD accounting model. Specifically, the FASB tentatively decided to (1) eliminate the distinction between PCD and non-PCD financial assets, (2) require an entity to apply the PCD model to all acquired assets (including those acquired in a business combination or asset acquisition), and (3) exclude from the scope of the PCD model certain credit cards and other revolving lending arrangements and AFS debt securities.

See Deloitte's Roadmap *Current Expected Credit Losses* for comprehensive discussions related to ASU 2016-13, including the highlights of the recently issued ASU 2022-02 that eliminates the accounting guidance on TDRs for creditors and amends the guidance on vintage disclosures.

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