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Understanding credit losses

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1. Understanding the current expected credit loss model

The FASB issued ASU 2016-13, "Measurement of Credit Losses on Financial Instruments" (hereafter Update) in June 2016. The effective date was for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years, an unusually long period. Despite that, at this writing, there is an exposure draft out for comment that would defer the implementation date for most entities until 2022.

The Update includes three new impairment models that apply to assets measured at amortized cost, available-for-sale debt instruments measured at fair value through other comprehensive income (FVOCI) and purchased financial assets with a more-than-insignifican amount of credit deterioration. The standard is tough to understand fully as there are several new concepts and procedures that are somewhat difficult to tease out of the Update, which is written as a mark-up of existing GAAP. This paper tries to lay out some of the basic features to help faculty and students understand the changes without going into detail on measurement.

2. Assets measured at amortized cost

The scope of the Update is very broad, including not only investments in held-to-maturity debt instruments but also financing and trade receivables, net investments in leased assets, and even off-balance-sheet credit exposures not accounted for as insurance. The FASB describes the model as measuring certain assets at the *net amount expected to be collected*. The current expected credit losses (CECL) are recognized in a valuation account, the allowance for credit losses, that is deducted from the amortized cost basis of the financial assets. The expected credit losses are recognized as a loss when the assets are initially recognized on the financial statements. Subsequent revisions to the estimate are recognized in net income as a loss or a gain (up to the amount of previously recognized losses).

2.1. CECL and fair value

CECL does away with a probability threshold for dealing with uncertainty in loss circumstances as described in ASC 450-20-05-4. Instead, uncertainty is accounted for using measurement, a fair value objective. Potential losses therefore are recognized on initial recognition of the asset.

Although uncertainty is dealt with using a fair value objective, it is not a fair value model. The measurement uses various entity-specific information about both the creditor and the borrower. There is no obligation to follow the requirements in ASC 820, Fair Value Measurement, (see ASC 820-10-55-1) or maximize the use of relevant observable inputs when measuring estimated credit losses (see ASC 820-10-05-01C).

Instead, CECL uses a Dickensian model that requires consideration of internal information, external information, or a combination of both relating to:

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- Past events,
- Present conditions, and
- Future conditions based on reasonable and supportable forecasts.

CECL does not include measurement of changes in the fair value of the asset due to factors other than expected credit losses, such as a change in market interest rates.

The standard includes guidance on how to evaluate financial instruments on a collective basis (see ASC 326-20-55-5). This differs from fair value where financial instruments are usually evaluated on a standalone basis (see ASC 820-10-35-2D). CECL treats financial instruments more like a reporting unit. The unit of account may be groups of assets with similar risk characteristics. Only individual assets that do not fit within a risk pool (do not have similar risk characteristics) are measured individually using a loss rate for similar assets (see ASC 326-20-55-23) or discounted cash flows for an individual loan (see ASC 326-20-55-35).

The FASB provided examples of how to estimate the allowance for credit losses using both collective and individual asset approaches (see ASC 326-20-55-17). For example, if Entity A originates loans with a contractual amount/amortized cost basis of three million dollars and determines after consideration of past events/experience, current conditions, and reasonable and supportable forecasts that the estimated credit losses over the lifetime of the loans is $50,000, the bank would record the following:

Loans at amortized cost	$3,000,000
Credit losses	50,000
Allowance for credit losses	$50,000
Cash	3,000,000
To record loan originations and the ACL for October	

Collectively, these changes constitute a new recognition and measurement model that is neither fair value nor a traditional amortized cost model. Its reliance on estimates based on past events, present conditions, and future forecasts will pose new issues for internal control and audits.

2.2. Other observations on CECL

1. ASU 2016-13 provides some relief on transition by not specifying a particular measurement model. Reporting entities will be able to use current practice as a starting point for preparing the estimates required to recognize an allowance for credit losses.
2. Unlike other impairment losses, losses recognized in the allowance for credit losses can be reversed in future periods.
3. In many situations, the carrying value of an individual asset is likely to be less than its fair value, especially on initial recognition when the purchase price is netted against the initial allowance for credit losses.
4. The allowance for credit losses does not change the calculation of the effective interest rate. Interest revenue is recognized using the amortized cost basis of the instrument, including amortization of any discount or premium.

3. Available-for-sale debt instruments measured at FVOCI

Although there would be many advantages to a single impairment model, for various reasons the FASB elected to promulgate a separate model for available-for-sale debt instruments. The overarching reason appears to be a conflict between CECL and fair value. As noted in the previous section, the carrying value of an individual asset is likely to be less than its fair value, especially on initial recognition. CECL information may be relevant for an asset that the entity intends to hold to maturity (realize value in use), but less so if the entity could realize value in exchange. Therefore, available-for-sale accounting recognizes that value may be realized either through collection of contractual cash flows or through sale of the security.

The accounting for available-for-sale debt securities is unchanged when the fair value of the instrument is greater than or equal to the amortized cost basis. Unrealized gains are recognized in other comprehensive income and reclassified into net income if the instrument is sold prior to maturity. The changes to the model occur when fair value is less than the amortized cost basis. The valuation account for changes in fair value will now consist of two components: changes in fair value recognized in other comprehensive income and the allowance for credit losses recognized in earnings. All changes in the allowance for credit losses, including reversals, will be recognized in net income.

There are two models for recognition of a decline in fair value less than the amortized cost basis:

- When the entity has the intent and ability to hold the instrument
- When the entity intends to sell the instrument or does not have the intent to hold.

The models differ in their accounting for noncredit losses, impact on the amortized cost basis of the assets, and the accounting for any recoveries.