In June 2016, the Financial Accounting Standards Board (FASB) issued its new guidance on credit losses in Accounting Standards Update (ASU) 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. While this standard is applicable to all entities, it is believed to be the most significant fundamental accounting change financial institutions and other lenders have ever faced.

What do I need to know about the new standard on credit losses?

This standard creates a new model for determining the allowance for credit losses known as CECL (current expected credit loss). The underlying premise of CECL is that the allowance for credit losses should reflect management’s current estimate of credit losses that are expected to occur over the remaining life of a financial asset. Under current guidance, only those losses that have been incurred to date are considered. Inherent in the requirement to estimate expected losses over the life of the asset is the need to incorporate reasonable and supportable forecasts about future economic conditions when estimating those future losses.

CECL applies to substantially all financial assets measured at amortized cost, which includes not only loans that will be held in the portfolio, but also accounts receivable, held-to-maturity (HTM) debt securities and off-balance-sheet credit exposures, such as commitments to lend. (As discussed further in our white paper, Financial instruments: In-depth analysis of standard on credit losses, the standard also contains new guidance relevant to available-for-sale debt securities that is consistent with existing guidance in many respects.)

The expectation is that implementation of the new standard will result in increases in the allowances for credit losses, due not only to the movement from an incurred loss model to an expected loss model, but also the following:

- The need to include losses even if the risk of loss is remote
- The need to recognize expected credit losses on HTM debt securities, regardless of the relationship between fair value and amortized cost and regardless of whether the impairment is other than temporary
- The recognition of an allowance on purchased financial assets
- The inability to conclude no allowance is necessary based solely on the current value of collateral, unless justified through an allowable practical expedient

Additionally, we expect the new requirements to estimate losses that will occur over the remaining life of an asset and to consider reasonable and supportable forecasts about future conditions will increase the level of subjectivity, complexity and estimation uncertainty inherent in the allowance for credit losses, further elevating the importance of the internal controls around this process.

When will the new standard be effective?

The effective dates differ depending on the status of the reporting entity as follows:

- **SEC filers**: Fiscal years beginning after December 15, 2019, including interim periods within those years (January 1, 2020, for calendar year-end entities)
- **Public business entities other than SEC filers**: Fiscal years beginning after December 15, 2020, including interim periods within those years (January 1, 2021, for calendar year-end entities)
- **All other entities**: Fiscal years beginning after December 15, 2020, and interim periods thereafter (2021 for calendar year-end entities)
Entities are permitted to early adopt the new standard for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

What should management do now to prepare?

While the new standard is not effective immediately, we anticipate that implementation will be a time-consuming process for entities that hold significant long-term assets subject to its scope. We encourage entities to start the implementation process now as they may need to gather data that has not been retained in the past, such as life of asset loss rates. If this data-gathering process is started now, a base using the new data can be captured in a desired format. It will also be prudent to allow sufficient implementation time to have the new approach to estimating credit losses in place to run parallel with the existing approach for a period of time, which will allow for testing and issue resolution before transitioning to the new approach. Specific actions that management may want to take are illustrated to the right.

What are the key aspects our governing body should focus on?

While management is ultimately responsible for implementing the new standard, those charged with governance will need to play a crucial role in oversight given the potential magnitude of this change to the entity and the potential risk of material misstatement to the financial statements. Specific questions we would expect the governing body to focus on are illustrated to the right.

Where can I go for additional information?

Refer also to our white paper, Financial instruments: In-depth analysis of new standard on credit losses and ASU 2016–13.