

# Ramifications of the New Standard on Credit Losses to Non-Lenders

December 3, 2020



# Ramifications of the New Standard on Credit Losses to Non-Lenders

CPE Credit: 1.5

---

Sponsored by:



© 2020 RSM US LLP. All Rights Reserved.  
This material may not be reproduced by  
anyone outside of RSM US without the  
firm's express written consent.

# Your instructors



**Faye Miller**

Partner, National accounting  
policy leader

+1 410 246 9194

Faye.Miller@rsmus.com



**Mike Gaiso**

Sr. Director, Accounting  
standards group

+1 212 372 1709

Michael.Gaiso@rsmus.com

# Agenda

Topic	Minutes
Overview of the credit losses standard	5
ASC 326-20:	
What has changed	10
Key aspects	45
Acquired assets	10
ASC 326-30 – What has changed	10
Disclosure requirements	5
Transition	5

# Overview of the credit losses standard

# ASU 2016-13 – Why is it a big deal?

- Consists of ASC 326-20 (amortized cost assets) and ASC 326-30 (AFS debt securities)
- Substantially all assets within the scope of ASC 326-20 will require an allowance for expected (rather than incurred) credit losses including:
  - Cash equivalents
  - HTM debt securities (regardless of the relationship between fair value and amortized cost)
  - Receivables and contract assets, including those that are current or from pristine customers
  - Purchased/acquired financial assets (e.g. loans, receivables, HTM securities)
  - Financing receivables, loans and net investments in leases

## ASU 2016-13 – Why is it a big deal? (Cont.)

- Under ASC 326-30, AFS debt security will require an allowance for credit losses if its fair value is less than amortized cost and there are indications of credit impairment
  - Can no longer rely on post-balance sheet fair value recoveries or brief period of time in an unrealized loss position to avoid recognizing a loss
  - Write-downs to fair value continue to be required if the entity intends to sell the security or its more likely than not that it will be required to sell the security

# Effective dates

	<b>PBE SEC filers (other than SRC)</b>	<b>All other</b>
Fiscal years (including interim periods) beginning after	12/15/19	12/15/22
Adoption date for calendar year end entity	1/1/20	1/1/23
Early adoption permitted for fiscal years beginning after 12/15/18, including interim periods within those fiscal years		



# Polling question 1

- What is your status of adoption?
  - A. Early adopted
  - B. Required to adopt for my fiscal year beginning after 12/15/19
  - C. Required to adopt for my fiscal year beginning after 12/15/22
  - D. Other/not applicable

ASC 326-20

# What has changed

Financial assets measured at amortized cost

# ASC 326-20: Financial assets measured at amortized cost

## In scope (ASC 326-20-15-2)

- Financial assets measured at amortized cost including:
  - Loans
  - Receivables and contract assets
  - HTM debt securities
  - Cash equivalents
- Reinsurance recoverables
- Net investments in leases
- Certain off-balance-sheet credit exposures

## Out of scope (ASC 326-20-15-3)

- Assets measured at fair value
- Equity securities
- AFS debt securities
- Loans held for sale
- Loans made to participants by defined contribution plans
- Insurance co. policy loans receivable
- Pledges receivable of an NFP entity
- Loans and receivables between entities under common control
- Operating lease receivables

# Receivables – What has changed?

<b>Pre-existing guidance (ASC 450-20 and ASC 310-10-35)</b>	<b>New (ASC 326-20)</b>
Recognize incurred losses	Recognize losses that are expected to occur over the contractual life, including even remote risks of loss
Assets could, but were not required to be evaluated collectively	Assets with similar risk characteristics are required to be evaluated collectively
When estimating expected credit losses, consideration was given to current conditions but not reasonable and supportable forecasts	When estimating expected credit losses, historical loss information should be adjusted for differences in current conditions and reasonable and supportable forecasts
Ramifications: Loss recognition is accelerated and nearly all receivables will have an allowance	

# HTM debt securities – What has changed?

Pre-existing guidance (ASC 320-10-35)	New (ASC 326-20)
Securities were required to be evaluated individually	Assets with similar risk characteristics are required to be evaluated collectively
Loss was recognized (through direct writedown) only if fair value of security was less than carrying amount <b>and</b> either (1) the entity intended to sell the security, (2) it is more likely than not that the entity would be required to sell the security before it recovered, or (3) the entity did not expect to recover the amortized security's cost basis	Recognize expected credit losses through an allowance. No consideration is given to intent or more likely requirement to sell or the relationship of the security's fair value to its amortized cost
Expected credit losses were based on management's best estimate. In certain circumstances, a conclusion could be reached qualitatively that expected credit losses are zero	Even remote risks of loss need to be considered when estimating expected credit losses

# HTM debt securities – What has changed? (Cont.)

<b>Pre-existing guidance (ASC 320-10-35)</b>	<b>New (ASC 326-20)</b>
Discounted cash flows approach was required when quantifying expected credit losses	Discounted cash flows approach may be used when quantifying expected credit losses and is required for beneficial interests within scope of ASC 325-40
After recognizing a credit loss, improvements in expected cash flows were accreted into interest income over the remaining life of the security	Favorable and unfavorable changes in expected cash flows are recognized immediately through an adjustment to the allowance and credit loss expense
Ramifications: Loss recognition is accelerated. Further, with the exception of US Govt and agency securities, nearly all HTM securities will have an allowance	

## Polling question 2

- Financial assets on your balance sheet (check all that apply):
  - A. AFS debt securities
  - B. HTM debt securities
  - C. Cash equivalents
  - D. Short-term receivables
  - E. Long-term receivables
  - F. Loans
  - G. Financial assets acquired in business combinations



# Key aspects

Financial assets measured at amortized cost

# Key aspects of ASC 326-20 – Pooling assets

- Measure expected credit losses on a pool basis whenever similar risk characteristics exist (ASC 326-20-30-2)
- Examples of how to pool assets (ASC 326-20-55-5)
  - Credit scores, credit ratings or risk ratings of obligor
  - Asset type
  - Collateral type
  - Geographical location of obligor
  - Industry of obligor
  - Size of financial asset or term
- Continuously reassess

# Example of pooling trade accounts receivable

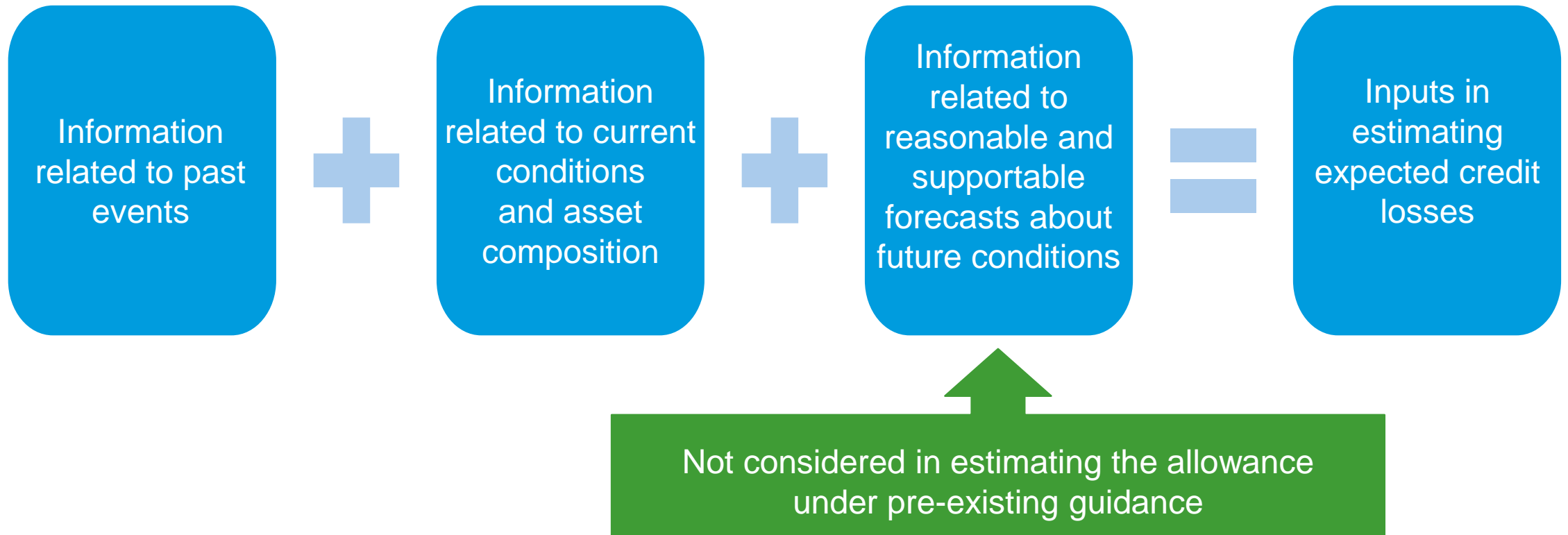
- ABC Corporation sells furniture to wholesalers and retail outlets in U.S., Canada and Mexico
- ABC Corporation pools its trade accounts receivable first by geography, then by customer type, and then by aging as these factors seem to have the most impact on collectability.

Geography	Customer Type	Current	31-60	61-90	90+
United States	Wholesalers	\$XXX	\$XXX	\$XXX	\$XXX
	Retail	\$XXX	\$XXX	\$XXX	\$XXX
Canada	Wholesalers	\$XXX	\$XXX	\$XXX	\$XXX
	Retail	\$XXX	\$XXX	\$XXX	\$XXX
Mexico	Wholesalers	\$XXX	\$XXX	\$XXX	\$XXX
	Retail	\$XXX	\$XXX	\$XXX	\$XXX

## Polling question 3

- What may be an appropriate way to aggregate HTM securities
  - A. By credit rating
  - B. By industry of the obligor
  - C. By type of collateral
  - D. All of the above

# Key aspects of ASC 326-20 – How to estimate losses (ASC 326-20-30-7 to 30-9)



# Typical process for estimating losses

Start with historical loss rates on assets w/similar risk characteristics

Adjust historical loss rates for current and forecasted conditions

- Should be reflective of contractual term, with consideration given to prepayments and extensions/renewals that are not unconditionally cancellable or associated with expected troubled debt restructurings
- Could be based on relevant internal data, external data or a combination
- Do not need to be most recent historical period
- Should consider all components of amortized cost basis, including unamortized premiums or discounts

## Polling question 4

- When selecting the historical loss period, what is the correct answer?
  - A. Be consistent (i.e., if you use the most recent two years, you should always use the most recent two years)
  - B. Select the historical period that most closely resembled current and forecasted economic conditions
  - C. Select the historical period during which the composition of the assets most closely resembled the current period
  - D. None of the above

# Typical process for estimating losses (Cont.)

Start with historical loss rates on assets w/similar risk characteristics

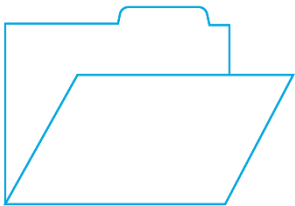
Adjust historical loss rates for current and forecasted conditions

- Consider factors that are relevant to the collectibility of the assets and how those factors compare in the current and forecasted period to the historical loss rate period. For example,
  - Are the customers'/obligors' financial condition, business prospects and ability to pay better or worse than the historical period?
  - Are economic conditions (e.g., unemployment) better or worse?
  - Are the level of delinquencies higher or lower?
  - Is there more or less collateral coverage?
  - Have there been any changes to credit terms?
- Adjust historical losses +/- for differences to arrive at best estimate of expected credit losses



# Incorporating forecasts

- How far out to forecast?
  - Dependent on period of time for which entity can make or obtain reasonable and supportable forecasts
  - May be contractual life for short-term assets
  - Subjective and should be continuously re-evaluated
  - May have little impact for short-term receivables however, more impact for debt securities, contract assets and other long-term receivables
- If contractual life of asset extends beyond forecast period, revert to historical loss information for periods beyond forecast



Refer to FASB Staff Q&A Topic 326, No. 2: *Developing an Estimate of Expected Credit Losses on Financial Assets* for additional info

# Key aspects of ASC 326-20 – Methodology (ASC 326-20-30-3)

No one method required. Some examples:

Discounted  
cash flows

Loss rate  
methods

Roll-rate  
methods

Probability  
of default  
methods

Based on  
an aging  
analysis

# Estimating expected credit losses for trade receivables using an aging schedule (adapted from ASC 326-20-55-37 to 55-40)

- Reminder: Start with historical losses, adjust for current conditions and reasonable and supportable forecasts

Aging	Amortized Cost Basis	Historical Losses	Expected Decrease	Projected Losses	Expected Credit Loss Estimate
Current	\$ 5,984,698	0.3%	10.0%	0.27%	\$ 16,159
1 - 30 days past due	8,272	8.0%	10.0%	7.20%	596
31 - 60 days past due	2,882	26.0%	10.0%	23.40%	674
61 - 90 days past due	842	58.0%	10.0%	52.20%	440
> 90 days past due	1,100	82.0%	10.0%	73.80%	812
	<u>\$ 5,997,794</u>				<u>\$ 18,681</u>

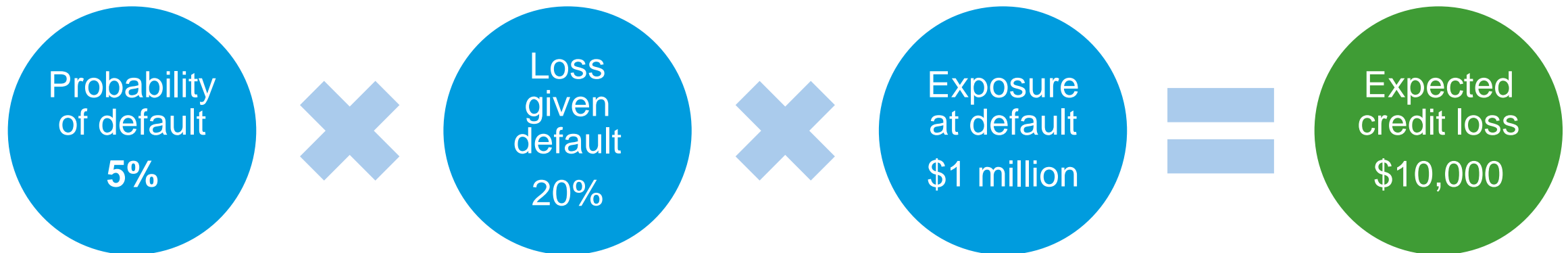
Current composition of receivables deemed consistent with historical period however current and forecasted economic conditions have improved, warranting 10% decrease to historical loss rates to arrive at projected.

# Simplistic example – Estimating losses on a security using probability of default method

## Fact pattern:

- Security is a corporate bond with an amortized cost basis of \$1 million
- Management estimates the probability of the bond going in to default to be 5% and the loss given default to be 20%

## How it works:



# Simplistic example – Estimating losses on a security using probability of default method, continued

## How are inputs for probability of default and loss given default determined?



Reminder: Start with historical information, adjust for current conditions and asset composition and reasonable and supportable forecasts

- Management may not have relevant internal data and may need to obtain relevant and reliable external data and consider use of specialist
- Examples of external data to consider:
  - Historical default and loss information on securities with similar risk characteristics
  - Industry analyst reports and forecasts to aid in factoring in current conditions and reasonable and supportable forecasts

# Key aspects of ASC 326-20 – Is expectation of zero loss supportable?

ASC 326-20-30-10 requires the estimate of expected credit losses to include even remote risks of credit loss



In limited circumstances, may reach conclusion expected credit losses are zero for particular assets such as:

U.S. Government and Agency-backed securities (ASC 326-20-55-48 to 55-50)

Certain assets fully secured by collateral as discussed at 326-20-35-5 and 35-6

Other?

Need to have documented process

# Illustration considering remote risks of loss (adapted from ASC 326-20-55-48 to 55-50)

	<b>U.S. Treasury securities</b>	<b>A-Rated Corporate Bonds</b>	<b>Receivables from Fortune 500</b>
Possibility of default	Yes	Yes	Yes
History of credit losses	No	Yes	Yes
Can print its own currency, which is viewed as a reserve currency and used in international commerce	Yes	No	No
Zero expected credit loss supportable at this time	Yes	Generally not	Generally not

## Polling question 5

- One of ABC Co's major customers is Walymart. During its 10 year history of selling to Walymart, all amounts due were collected on a timely basis. Select the most appropriate response:
  - A. In light of not experiencing any losses over 10 years, ABC Co may conclude no allowance is necessary for Walymart receivables
  - B. ABC Co may need an allowance depending on how it adjusts zero historical losses for current conditions and reasonable and supportable forecasts
  - C. ABC Co would recognize an allowance on Walymart receivables based on historical losses with assets with similar risk characteristics, with adjustments for asset specific characteristics, current conditions and reasonable and supportable forecasts



## Polling question 6

- For a contract to exist, and revenue to be recognized, ASC 606-10-25-1 requires it to be probable that substantially all of the consideration will be collected. In light of that,
  - A. At initial recognition of a receivable, no allowance for credit losses would be recognized however one may be required later if circumstances change
  - B. At initial recognition of a receivable, an allowance for expected credit losses would be recognized through credit losses expense
  - C. At initial recognition of a receivable, an allowance for expected credit losses would be recognized through a reduction to revenue
  - D. None of the above

# Key aspects of ASC 326-20: Interaction with ASC 606

- Upon recognizing a receivable, recognize an allowance through credit loss expense (ASC 606-10-45-4)
- ASC 326-20 also applies to contract assets (ASC 606-10-45-3)

## Receivable

- Right to consideration that is unconditional (i.e., only the passage of time is required before payment of that consideration is due)

## Contract asset

- Right to consideration that is conditioned on something other than the passage of time (e.g., future performance).

# Acquired assets

# Acquired financial assets– What has changed?

Pre-existing guidance (ASC 310-30, ASC 805)	New (ASC 326-20, ASC 805)
Acquisition date allowance was not recognized, given assets were recorded at fair value, which presumably gave consideration to credit losses	<p>Acquisition date allowance is recognized for expected credit losses (on remaining principal balance for purchased with credit deterioration (PCD) assets rather than amortized cost basis, as is otherwise the case). ASC 326-20-30-5 prohibits discounts that will be accreted into interest income from being offset against expected credit losses</p> <p>For PCD assets, initial allowance is recognized through an increase to the amortized cost basis of the asset, rather than credit loss expense as is otherwise the case</p>
For assets acquired with deteriorated credit quality, subsequent increases in expected cash flows were accreted into interest income over the asset's remaining life	Both favorable and unfavorable changes in expected cash flows are recognized immediately through credit loss expense
Ramifications: Nearly all acquired assets within the scope of ASC 326-20 will have an acquisition date allowance, with acquisition date expense recognition for those assets that are not PCD	

## Polling question 7

- Acquired assets within the scope of ASC 326-20 will generally have an acquisition-date allowance
  - A. Only if they show signs of post-origination credit deterioration at the acquisition date
  - B. Regardless of whether they show signs of credit deterioration at the acquisition date
  - C. Rarely since acquired assets are recognized at fair value and fair value gives consideration to expected credit losses

## Example of Acquisition of a PCD Asset versus Non-PCD Asset

- ABC Manufacturing Corp, purchases an HTM security with a par value of \$1,000,000 on March 1, 2020 for \$990,000.
- Security was deemed to be purchased with credit deterioration (PCD).
- Expected credit losses were estimated to be \$15,000 at the date of acquisition.
- At acquisition, the following journal entry is recorded:

HTM debt security	\$ 1,000,000	
Premium on security	\$ 5,000	
Allowance for credit losses		\$ 15,000
Cash		\$ 990,000

# Example of Acquisition of a PCD Asset versus Non-PCD Asset

- Assume the same fact pattern except the HTM debt security was not PCD
- At acquisition, the following journal entry is recorded:

HTM debt security	\$ 1,000,000	
Credit loss expense	\$ 15,000	
Allowance for credit losses		\$ 15,000
Discount on security		\$ 10,000
Cash		\$ 990,000

# Comparison of PCD versus Non-PCD example

	PCD	Non-PCD
Income statement effect of recognition of initial allowance	\$0	\$(15,000)
Life of asset income statement effect of amortization of premium or discount	(5,000)	10,000
Net income statement effect	\$(5,000)	\$(5,000)



# Identifying PCD assets

What constitutes a “more-than-insignificant” deterioration in credit quality (limited guidance provided, subjective guidance assessment, deterioration since origination is required)

Consider factors like delinquency, downgrades, or other indicators of increased credit risk

Accounting implications

# ASC 326-30 – What has changed

Available-for-sale debt securities



# AFS debt securities – What has changed and what remained the same?

Pre-existing guidance (ASC 320-10-35)	New (ASC 326-30)
AFS debt securities are required to be evaluated individually	Same
Loss was recognized only if fair value of security was less than carrying amount <b>and</b> either (1) the entity intended to sell the security, (2) it is more likely than not that the entity would be required to sell the security before it recovered, or (3) the entity did not expect to recover the security's amortized cost basis	Same criteria for loss recognition however credit losses are recognized through an allowance (limited to the amount the amortized cost exceeds fair value) rather than direct writedown
Expected credit losses were based on management's best estimate. In certain circumstances, a conclusion could be reached qualitatively that expected credit losses are zero	Same as pre-existing guidance; however, in determining if a credit loss exists, consideration should no longer be given to the length of time the security has been impaired or to recoveries or additional declines in the fair value after the balance sheet date

# AFS debt securities – What has changed and what remained the same? (continued)

Pre-existing guidance (ASC 320-10-35)	New (ASC 326-30)
Discounted cash flows approach to quantifying expected credit losses was required.	Discounted cash flows approach continues to be required however there is more flexibility to project changes in interest rates for variable rate securities and to adjust the discount rate for expected prepayments
After recognizing a credit loss, improvements in expected cash flows were accreted into interest income over the remaining life of the security	Favorable and unfavorable changes in expected cash flows are recognized immediately through an adjustment to the allowance and credit loss expense
Ramifications: Loss recognition is accelerated. Given the inability to consider the duration of the impairment and post-balance sheet recoveries, expected credit losses will more frequently need to be quantified and recognized.	

# AFS debt securities – What has changed and what remained the same? (continued)

Pre-existing guidance (ASC 320-10-35)	New (ASC 326-30)
<p>No impairment or allowance was recognized upon purchasing a security</p>	<p>If at the time of purchase a security has experienced a more-than-insignificant deterioration in credit quality since its origination, an allowance for expected credit losses is recognized through an increase to the security's initial carrying amount</p> <p>Both subsequent increases and decreases in expected credit losses on such a security are recognized immediately through a reduction or increase in credit loss expense</p>

## Amended considerations in determining if a credit loss exists (ASC 326-30-55-1)

- The ~~length of time and~~ extent to which fair value is  $<$  amortized cost
- Adverse conditions related to the security (e.g., deterioration in issuer's or underlying obligors' financial condition, deterioration in collateral values), industry or geographic area
- ~~Historical and implied fair value volatility~~
- Payment structure and ability of issuer being able to make payments that increase in the future
- Failure of the issuer to make scheduled payments
- Changes in the rating of the security
- ~~Post balance sheet recoveries or additional declines in fair value~~
- Other

## Polling question 8

- An AFS security has been in an unrealized loss position for less than one year. No adverse conditions about the security have come to management's attention. Scheduled payments have been received to date and the fair value partially recovered subsequent to year end. What else should be considered before concluding there are no expected credit losses?
  - A. Nothing given the short duration of the impairment and partial recovery
  - B. Whether there have been changes in the security's credit rating
  - C. The ability of the obligor to make remaining payments
  - D. Both B and C and other information relevant to its collectability

# Disclosure requirements



# Disclosure requirements, in part (ASC 326-20-50)

- Assets within the scope of ASC 326-20 (amortized cost):
  - Allowance disclosures and rollforward as well as disclosures of past due and non-accrual assets will continue to be required and now also apply to HTM securities
  - New disclosure for collateral dependent financial assets:
    - Description of the type of collateral
    - Qualitative description of the extent of collateral
    - Significant changes in collateral coverage




## Disclosure requirements, in part (ASC 326-20-50 and 30-50) (Cont.)

- Disclosures by credit quality indicator will be required for assets within scope of ASC 326-20 including HTM securities, but excluding most trade receivables due in one year or less
  - Further disaggregation by year of origination required by PBEs for net investment in leases and financing receivables
    - Required for most recent five years with transition ramp up for non-SEC filers
- AFS debt securities - Current disclosures substantially retained plus allowance rollforward



# Example – credit quality disclosures by origination year (ASC 326-20-55-79)

As of December 31, 20X5	Term Loans Amortized Cost Basis by Origination Year									
	20X5	20X4	20X3	20X2	20X1	Prior	Revolving Loans Amortized Cost Basis	Revolving Loans Converted to Term Loans Amortized Cost Basis	Total	
<b>Residential Mortgage:</b>										
<b>Risk Rating</b>	 <div data-bbox="879 592 2012 706" style="border: 1px solid black; padding: 5px; display: inline-block;">                     Similar disclosures would be required for the other classes of assets subject to this requirement                 </div>									
1-2 Internal grade	\$ XX	\$ XX	\$ XX	\$ XX	\$ XX		\$ XX	\$ XX	\$ XX	\$ XX
3-4 Internal grade	XX	XX	XX	XX	XX		XX	XX	XX	XX
5 Internal grade	XX	XX	XX	XX	XX		XX	XX	XX	XX
6 Internal grade	XX	XX	XX	XX	XX		XX	XX	XX	XX
7 Internal grade	XX	XX	XX	XX	XX		XX	XX	XX	XX
<b>Total residential mortgage loans</b>	\$ XX	\$ XX	\$ XX	\$ XX	\$ XX		\$ XX	\$ XX	\$ XX	\$ XX
<b>Residential Mortgage loans:</b>										
<b>Current-period gross writeoffs</b>	\$ XX	\$ XX	\$ XX	\$ XX	\$ XX		\$ XX	\$ XX	\$ XX	\$ XX
<b>Current-period recoveries</b>	XX	XX	XX	XX	XX		XX	XX	XX	XX
<b>Current-period net writeoffs</b>	\$ XX	\$ XX	\$ XX	\$ XX	\$ XX		\$ XX	\$ XX	\$ XX	\$ XX

# Transition

ASU 2016-13

# Transition (ASC 326-10-65)

- Generally cumulative-effect adj to opening retained earnings
- Prospective application for:
  - PCD assets (accounted for under ASC 310-30) and beneficial interests w/ a significant difference between contractual and expected cash flows - allowance is recognized through increase to assets' amortized cost basis
  - Debt securities that had OTTI recognized pre-adoption – improved cashflows previously recognized in OCI continue to be accreted to interest income
- Can adopt fair value option for qualifying assets within scope of ASC 326-20 (except HTM securities)

# Additional Resource

## A guide to accounting for investments, loans and other receivables (with chapters on credit losses)





# QUESTIONS AND ANSWERS

THANK YOU FOR  
YOUR TIME AND  
ATTENTION



## RSM US LLP

One South Wacker Drive, Suite 800  
Chicago, IL 60606  
312.634.3400

+00 (1) 800 274 3978  
[www.rsmus.com](http://www.rsmus.com)

This document contains general information, may be based on authorities that are subject to change, and is not a substitute for professional advice or services. This document does not constitute audit, tax, consulting, business, financial, investment, legal or other professional advice, and you should consult a qualified professional advisor before taking any action based on the information herein. RSM US LLP, its affiliates and related entities are not responsible for any loss resulting from or relating to reliance on this document by any person.

RSM US LLP is a limited liability partnership and the U.S. member firm of RSM International, a global network of independent audit, tax and consulting firms. The member firms of RSM International collaborate to provide services to global clients, but are separate and distinct legal entities that cannot obligate each other. Each member firm is responsible only for its own acts and omissions, and not those of any other party. Visit [rsmus.com/aboutus](http://rsmus.com/aboutus) for more information regarding RSM US LLP and RSM International.

RSM® and the RSM logo are registered trademarks of RSM International Association. The power of being understood® is a registered trademark of RSM US LLP.

© 2020 RSM US LLP. All Rights Reserved.

