Certified Public Accountants
Business & Financial Advisors

Credit Losses - Not Just for Banks

November 2023

Housekeeping

- This session is being recorded.
- Slides and recording will be sent to you after the session concludes.
- CPE Certificates will be emailed to you within two weeks.
- In the event of technical difficulties, please bear with us!
- If you have a question, please use the Q&A button at the bottom of your screen, and we will follow up after the webinar to answer your questions.

You are viewing Success Onboardin...'s screen

View Options

Zoom Video Co[...]
was Named a 20[...]
Peer Insights Cu[...]
for Meeting Solu[...]

Enter your work email

Gartner peerinsights

Figure 1. Gartner Peer Insights "Voice of the Customer" Meeting Solutions Overall Ratings

Gartner Peer Insights "Voice of the Customer" Meeting Solutions Overall Ratings

As of January 31, 2018

Source: [...] Peer Insights (January 31, 2018)

Q&A

You asked: 19:41

Type your questions and comments here!

Please input your question

Send Anonymously

Send

Gartner. Zoom received a 4.69 out of 5 overall customer [...]

Read the Report

Audio Settings

Chat

Raise Hand

Q&A

Leave Meeting

Disclaimer

These materials were prepared solely for the purpose of general education. They are distributed with the understanding that Insero & Co. CPAs, LLP and its Partners and employees are not engaged in rendering legal, accounting, or other professional service as part of this presentation. Statements and opinions are those of the presenters or participants only. This presentation may be recorded and published without further notice.

The information contained herein is general in nature and based on authorities that are subject to change. Insero & Co. CPAs, LLP guarantees neither the accuracy nor completeness of any information and is not responsible for any errors or omission, or for results obtained by others as a result of reliance upon such information. Insero & Co. CPAs, LLP assumes no obligation to inform the reader of any changes in laws or other factors that could affect information contained herein. This publication does not, and is not intended to, provide legal, tax or accounting advice, and readers should consult their advisors concerning the application of laws to their particular situation.

Agenda

- Overview
- Deeper dive into ASC 326-20 (amortized cost)
- High level look at ASC 326-30 (AFS securities)
- Disclosure changes

1st Polling Question

Where do you stand in adopting the new credit loss guidance??

A. Already done
B. You don’t think it applies to you
C. Just starting
D. What is a credit loss?

Credit Losses – What is New?

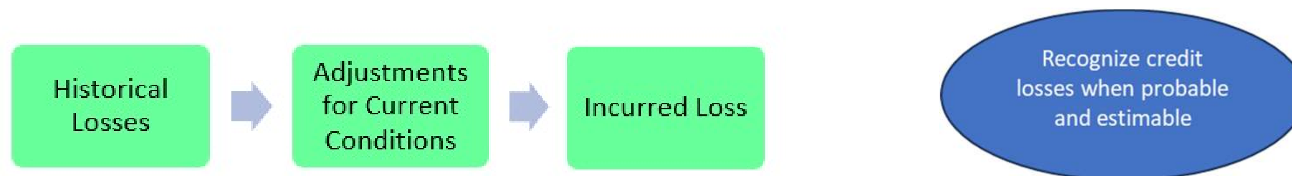
In June 2016 – the FASB issued ***ASU 2016-13, Financial Instruments – Credit Losses (ASC 326); Measurement of Credit Losses on Financial Instruments***

The guidance represents significant changes to accounting for credit losses.

- Replaces the legacy "incurred loss" methodology for recognizing credit losses with an "expected losses" model.
- Losses should be recognized upon initial recognition of an asset.

Key Changes

Legacy GAAP = Incurred Loss Method



New Guidance = Current Expected Credit Loss/CECL

Why is it a big deal?

While the new standard will have a significant effect on the financial service industry—particularly banks and others with lending operations (such as credit unions)—**it will affect entities in all industries** as a wide variety of financial instruments are within the scope of this new guidance, **including trade receivables**.

Why is it a big deal? - Continued

To complicate matters further, the new guidance introduces two distinctive credit loss impairment models

- One for financial assets measured at amortized cost (ASC 326-20)
- One for available for sale debt securities (ASC 326-30)

Assets Measured at Amortized Cost

Substantially **all assets** within the scope of ASC 326-20 will require an allowance for expected (rather than incurred) credit losses including:

- Held to maturity (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 (lessors)

AFS Debt Securities

Available for sale (AFS) debt securities 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 to avoid recognizing a loss
- Even being in an unrealized loss position for a brief period of time requires loss recognition
- Writedowns to fair value continue to be required if the entity intends to sell the security or more likely than not will be required to

Effective Date

Private Companies must adopt ASC 326 for fiscal years beginning after December 15, 2022

In other words - Calendar 2023

Second Polling Question

What factors should be considered in the new expected loss method

A. Historical losses

B. Asset specific risk

C. Reasonable and supportable forecasts

D. All of the above

ASC 326-20

ASC 326-20: Financial assets measured at amortized cost

In scope

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

Out of scope

- Assets measured at fair value
- Equity securities
- AFS debt securities (see 326-30)
- 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

Impact on Receivables

Pre-existing guidance (ASC 450-20 and ASC 310-10-35)	New (ASC 326-20)
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 losses, consideration was given to current conditions but not reasonable and supportable forecasts	When estimating expected losses, historical loss information should be adjusted for differences in current conditions and reasonable and supportable forecasts
Impact: Loss recognition is accelerated and nearly all receivables will have an allowance	

Impact on HTM debt securities

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 **and** either (1) the entity intended to sell the security, (2) it was more likely than not it would be required to sell before it recovered, or (3) the entity did not expect to recover the amortized 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 and could be zero	Even remote risks of loss need to be considered when estimating expected credit losses

HTM debt securities – What has changed? (continued)

Pre-existing guidance (ASC 320-10-35)	New (ASC 326-20)
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

Impact: Loss recognition is accelerated and nearly all HTM securities will have an allowance (with maybe exception of US Government & agency securities)

Pooling assets

New Guidance - Measure expected losses on a **pool basis** whenever **similar risk** characteristics exist

Examples of how to pool assets

- 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

- XYZ Corporation sells televisions to wholesalers and retail outlets in U.S., Canada and Mexico
- XYZ 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

Third Polling Question

Which of the below may not an appropriate way to aggregate trade receivables

A. By credit rating

B. By size

C. By personal relationship with customer

D. None of the above

How to estimate losses?

Process for estimating losses – Historical Loss Rates

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

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

Process for estimating losses – Asset Specific Characteristics

Differences between the assets existing at the reporting date and the assets included in the historical credit loss experiences

- ✓ Changes in underwriting standards
- ✓ Changes in the portfolio mix
  - ❖ Loans or client/customer base
- ✓ Changes in the contractual terms of the assets

Process for estimating losses – Current & Forecasted Conditions

- Consider factors that are relevant to the collectability 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' financial condition, business prospects and ability to pay better or worse than the historical period?
  - Are economic conditions (e.g., unemployment, inflation) 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 losses

Process for estimating losses - Incorporating forecasts

How far out to forecast?

- Should be for a period of time that you can make or obtain reasonable and supportable forecasts
- May be contractual life for short-term assets
- Subjective and should be continuously re-evaluated

** Forecast may have little impact for short-term receivables. This is more applicable for debt securities, contract assets and other long-term receivables

Process for estimating losses – Current & Forecasted Conditions

- You are asking – How do we do this? How do we estimate the impact?
- Use relevant and available information **without undo cost and effort**
  - Relevant – does it impacts the assets being evaluated
    - For example, for a small New England retailer - use New England unemployment versus national unemployment
  - Available – publicly available external forecasts, internal or external experts
- DOCUMENT your assumptions

Methodology

No one method required or specified by ASC 326 – Options include

- Aging schedule
- Loss rate methods
- Probability of default methods
- Discounted cash flows
- Roll-rate methods

- *Because of the subjective nature of the estimate, this Subtopic does not require specific approaches when developing the estimate of expected credit losses. Rather, an entity should use judgment to develop estimation techniques that are applied consistently over time and should faithfully estimate the collectability of the financial assets by applying the principles in this Subtopic. An entity should utilize estimation techniques that are practical and relevant to the circumstance. The 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*.

Example - Trade receivables using an aging schedule

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
	$ 5,997,794				$ 18,681

This reflects the adjustment for current and forecasted conditions. Economic conditions have improved, warranting 10% decrease to historical loss rates to arrive at projected.

Example – Receivables using loss rate method – Option 1

ABC Company's loan portfolio at origination consists of:		
Unpaid principal	$ 100,000,000	
Loan origination costs	$ 2,000,000	
Amortized cost	$ 102,000,000	(b)
At the end of year 5, the outstanding balances are:		
Principal	$ 55,000,000	
Unamortized origination costs	$ 400,000	
Amortized cost	$ 55,400,000	(d)
At the end of year 5 - 10% of the loans defaulted. The historical loss rate is as follows:		
Unpaid principal (10% of original balance)	$ 10,000,000	
Unamortized costs related to defaulted loans	$ 100,000	
Amortized cost	$ 10,100,000	
Cash received in settlement	$ 8,000,000	
Write off	$ 2,100,000	(a)
Option 1: Calculate the loss rate as percentage of original amortized cost		
Historical Loss Rate	2.06%	(a)/(b)
Adjust for current/forecasted conditions	10%	
Rate to apply to original amortized cost in calculating credit allowance	2.26%	(c)
Reserve needed	$ 1,254,647	(c) x (d)

Example – Receivables using loss rate method – Option 2

ABC Company's loan portfolio at origination consists of:		
Unpaid principal	$ 100,000,000	(b)
Loan origination costs	$ 2,000,000	
Amortized cost	$ 102,000,000	
At the end of year 5, the outstanding balances are:		
Principal	$ 55,000,000	(d)
Unamortized origination costs	$ 400,000	
Amortized cost	$ 55,400,000	
At the end of year 5 - 10% of the loans defaulted. The historical loss rate is as follows:		
Unpaid principal (10% of original balance)	$ 10,000,000	
Unamortized costs related to defaulted loans	$ 100,000	
Amortized cost	$ 10,100,000	
Cash received in settlement	$ 8,000,000	
Write off	$ 2,100,000	(a)
Option 2: Calculate the loss rate as percentage of principal		
Historical Loss Rate	2.10%	(a)/(b)
Adjust for current/forecasted conditions	10%	
Rate to apply to original amortized cost in calculating credit allowance	2.31%	(c)
Reserve needed	$ 1,270,500	(c) x (d)

Example – Security using probability of default method

Company ABC has a corporate bond with an amortized cost basis of $1 million

Management estimates the probability of the bond going into default to be 5% and the loss given default to be 20%

Calculation: Expected loss = probability of default x loss given default x exposure at default

- 5% x 20% x $1 million=$10,000 expected losses

Example – Discounted cash flow method

Principal amount	$	100,000
Discount (deferred fees)	$	1,875
Contractual interest rate		10%
Effective interest rate (EIR)		10.5%

Year	Principal	Interest	Total CF	Expected CF	Expected Loss
1	$ -	$ 10,000	$ 10,000	$ 9,500	$ 500
2	$ -	$ 10,000	$ 10,000	$ 9,700	$ 300
3	$ -	$ 10,000	$ 10,000	$ 9,500	$ 500
4	$ -	$ 10,000	$ 10,000	$ 10,000	$ -
5	$ 100,000	$ 10,000	$ 110,000	$ 102,000	$ 8,000
Total			$ 150,000	$ 140,700	$ 9,300
Present value at EIR			**$ 98,129**	**$ 92,204**	**$ 5,925**
Allowance for credit loss					**$ 5,925**

Zero Loss?

ASC 326 requires the estimate of expected credit losses to include even remote risks of credit loss

In limited circumstances, zero expected credit losses may occur such as:

- U.S. Government and Agency-backed securities
- Certain assets fully secured by collateral (fair value less costs to sell of collaterial exceed amortized cost)

Documentation is required to support zero losses…

ASC 326-20 and Interaction with ASC 606

- Under ASC 606, for revenue recognition to occur, collection of the consideration must be probable (over 75%)
- It is not uncommon for a company's historical experience to indicate that it will not collect everything in a portfolio of contracts – even if each individual contract is probable. There will be an unidentified customer that doesn't pay.
- Therefore – even on day one – you would recognize an allowance through credit loss expense.
- This applies to both receivables and contract assets
  - 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). Includes unbilled receivables.

Lessor receivables

- For lessors with net investments in sales-type and direct financing leases recognized in accordance with ASC 842:
  - An allowance for credit losses should be recognized on net investment receivables on the date the sales-type or direct financing lease receivable is recognized
- The calculation of the allowance for credit losses should consider the contractual term (lease term) and includes unbilled receivables.

Acquired financial assets

- An allowance for credit loss is required to be recorded at time of acquisition
- With the exception of PCD assets, the allowance is recorded through credit loss expense
- Both favorable and unfavorable changes in expected cash flows (allowance) are recognized immediately through credit loss expense

Purchased with credit deterioration (PCD)

- ASC 326-20 introduced the term Purchased with Credit Deterioration (PCD) assets
- This replaces the old Purchased Credit Impaired (PCI) assets under ASC 310
- Under the new guidance, an allowance for credit loss is recorded at the time of acquisition.
- However, the allowance is not recorded through credit loss expense.
- 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

Example Acquisition of PCD asset

- On March 1, 2023, XYZ Company purchased a portfolio of financing receivables with a face value of $500,000 for $300,000
- Entire portfolio was deemed to be purchased with credit deterioration (PCD)
- Expected credit losses were estimated to be $200,000 at the date of acquisition
- At acquisition, the following journal entry is recorded:

	Debit	Credit
Receivables	$ 500,000	
Allowance for credit losses		$200,000
Cash		$300,000

Example Acquisition of a Non-PCD Asset

- Assume the same fact pattern as the PCD example except the receivable was not PCD (face value $500,000, purchased for $300,000; estimated credit loss $200,000)
- At acquisition, the following journal entry is recorded

Account	Debit	Credit
Receivables	$300,000	
Credit loss expense	$ 200,000	
Allowance for credit losses		$ 200,000
Cash		$ 300,000

Fourth Polling Question

One of ABC Co's major customers is University of Rochester (U of R). During its 20 year history of selling to the U of R, all amounts due were collected on a timely basis. Select the most appropriate response:

A. In light of not experiencing any losses over 20 years, ABC Co may conclude no allowance is necessary for U of R receivables

B. ABC Co may need an allowance depending on how they adjust zero historical losses for current conditions and reasonable and supportable forecasts

C. ABC Co would recognize an allowance on U of R receivables that is based on historical losses with assets with similar risk characteristics, with appropriate adjustments for asset specific characteristics, current conditions and reasonable and supportable forecasts

ASC 326-30 – What has changed

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 **and** either (1) the entity intended to sell the security, (2) more likely than not would be required to sell it before it recovered, or (3) the entity did not expect to recover the 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 losses are zero	Same 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

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

Pre-existing guidance (ASC 320-10-35)	New (ASC 326-30)
No impairment or allowance was recognized upon purchasing a security	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 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

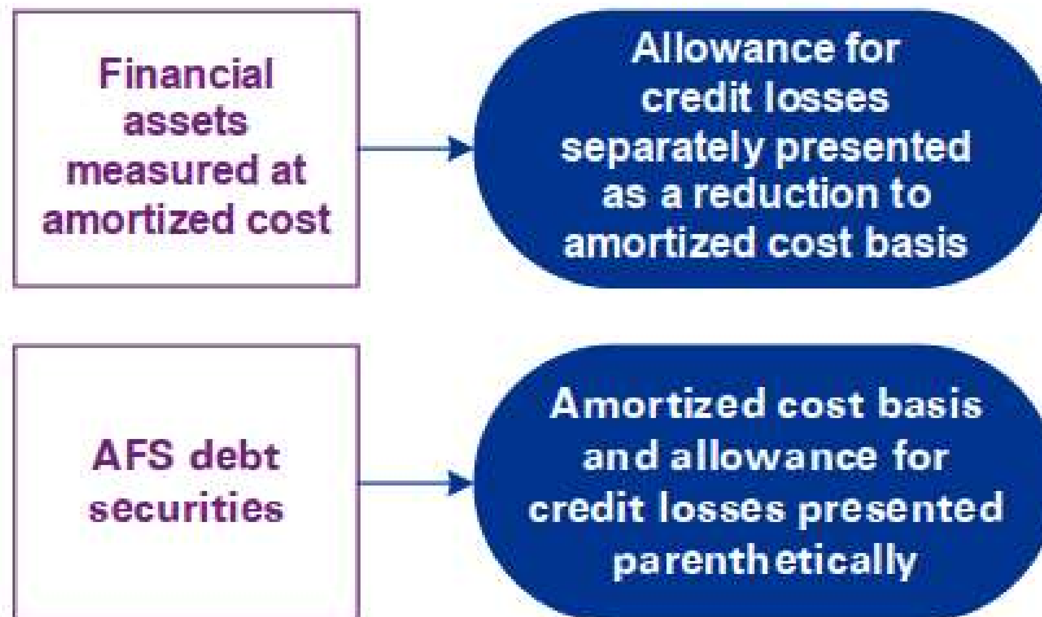
Overall: Loss recognition is accelerated. Given the inability to consider the duration of the impairment and post-balance sheet recoveries, expected credit losses will more frequently need to be quantified and recognized.

Disclosure requirements

Disclosure requirements – Year of adoption

- The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle
- The method of applying the change
- The effect of the adoption, if material, as of the beginning of the first period for which the content in the standard is effective.

Presentation – Balance Sheet



Presentation – Amortized Cost

Old Guidance	New Guidance
Balance Sheet - No specific presentation required; there is diversity regarding how allowance is presented	The allowance for credit losses for financial assets measured at amortized cost is **separately presented as a deduction from or addition to the assets amortized cost basis.** An entity may make an accounting policy election to present accrued interest receivable net of the related allowance for credit losses separately from the associated assets.
Income Statement **Loans & Receivables** - Credit losses reported as bad debt expense	Credit losses are presented as **credit loss expense.** An entity can elect to write off accrued interest receivable through interest income or recognizing credit loss expense.
HTM securities - Credit losses are presented as impairment losses. The change in PV of expected cash flows attributable to the passage of time is presented as interest income.	Credit losses are presented as **credit loss expense.** An entity can elect to write off accrued interest receivable through interest income or recognizing credit loss expense. The change in the PV of expected cash flows due to passage of time may be presented as credit loss or interest income.

Disclosure requirements - Changes

- Many of the ASC 326 disclosures are the same as under ASC 310. Most of the retained disclosures relate to entity's credit risk and evaluation of the allowance for credit loss.
- The changes with the "Expected Credit Loss Model" creates the need for additional disclosures including those about the inputs used to estimate expected credit losses.
- Disclosures now all apply to HTM securities as well
- Overall the disclosures should enable a user to understand
  - The credit risk inherent in a portfolio and how management monitors the credit quality of the portfolio
  - Managements estimate of expected credit losses
  - Changes in the estimate of expected credit losses during the period (i.e. allowance rollforward)
- For financing receivables (including lease receivables) an entity should provide information by either portfolio segment or class of financing receivable.
- For HTM securities, entity should provide information by major security type

Disclosure requirements – Changes continued

- New disclosure for collateral dependent financial assets:
  - Describe the type of collateral
  - Qualitative description of the extent of collateral
  - Significant changes in collateral coverage
- 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 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
Residential Mortgage:									
Risk Rating									
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
Total residential mortgage loans	$ XX	$ XX	$ XX	$ XX	$ XX	$ XX	$ XX	$ XX	$ XX
Residential Mortgage loans:									
Current-period gross writeoffs	$ XX	$ XX	$ XX	$ XX	$ XX	$ XX	$ XX	$ XX	$ XX
Current-period recoveries	XX	XX	XX	XX	XX	XX	XX	XX	XX
Current-period net writeoffs	$ XX	$ XX	$ XX	$ XX	$ XX	$ XX	$ XX	$ XX	$ XX

Similar disclosures would be required for the other classes of assets subject to this requirement

Questions?