

Snapshot

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COVID-19's impact on ASC 326 transition adjustment

The COVID-19 pandemic is roiling the global economy and, as a result, impacting financial reporting for most entities, particularly with regard to accounting estimates. One estimate that may be particularly impacted is the current expected credit losses model (CECL) under ASC 326.

ASC 326, *Financial Instruments – Credit Losses*, introduces a new accounting estimate to financial reporting requirements: the allowance for credit losses, estimated according to the CECL model. The CECL model applies to financial assets measured at amortized cost.

Adopting ASC 326

The new credit losses guidance in ASC 326 is effective as of Jan. 1, 2020, for entities that are SEC filers but are not designated as smaller reporting companies (SRCs) with calendar-year reporting dates.

Transition adjustment

ASC 326-10-65-1(c) requires an entity adopting ASC 326 to apply the guidance by means of a cumulative-effect adjustment to the opening retained earnings as of the beginning of the first reporting period of adoption. Accordingly, an entity will adjust opening retained earnings by estimating expected credit losses on its portfolio of financial assets measured at amortized cost as of the beginning of the fiscal year of adoption.

Estimating expected credit losses

The CECL model in ASC 326 requires entities to recognize an allowance for credit losses on financial assets measured at amortized cost as the difference

between the amortized cost basis of the financial asset and the amount the entity expects to collect. The CECL model can be thought of as having five components:

- Group financial assets with similar risk characteristics into estimation pools
- Select a method for measuring credit losses for each estimation pool
- Determine historical losses relevant to each estimation pool
- Adjust historical losses for current conditions and reasonable and supportable forecasts
- Revert to historical loss experience for any portion of an asset's contractual term that extends beyond the reasonable and supportable forecast period

For more on estimating expected credit losses under the CECL model, see our New Developments Summary, "[Measuring credit losses on financial instruments](#)."

Subsequent events and ASC 326

ASC 855-10-55-2(e) identifies changes in estimated credit losses on receivables arising after the balance-sheet date, but before financial statements are issued or available to be issued, as a nonrecognized subsequent event. However, the SEC staff in a [speech](#) delivered at the 2018 AICPA Conference on Current SEC and PCAOB Developments further clarified how to apply this guidance in certain circumstances.

Loan-specific information

The staff clarified that loan-specific information about factual conditions that existed at the balance-sheet

date should be included in an entity's estimate of expected credit losses. Examples of such information include

- Servicer reports that show the effects of payment experience (including delinquencies and prepayments) that occurred on or before the measurement date
- Appraisals that show information about the fair value of loan collateral as of or before the measurement date

Information relating to forecast assumptions

According to the SEC staff, information relating to forecasting assumptions used in estimating expected credit losses related to the measurement date that is received before an entity has completed an appropriate estimation process could be included in the entity's estimate of expected credit losses. That is, an entity may include information relating to forecasting assumptions used in estimating expected credit losses that is known or knowable as of the measurement date.

For instance, if after the balance-sheet date but before the entity's financial statements are issued or available to be issued, the U.S. government announces unemployment rates for a period that includes the measurement date, an entity may include such information in its estimation process regarding expected credit losses. While the unemployment rates may not have been available to the entity at the measurement date, the rates are known or knowable since the underlying economic condition (the rate of unemployment) existed and the U.S. government had access to the information.

However, an entity may not include in its estimate of expected credit losses information relating to forecasting assumptions used in estimating expected credit losses that is received before an entity has completed an appropriate estimation process if that information does not relate to the measurement date. To include such information would violate the guidance in ASC 855-10-55-2(e), which precludes recognizing changes in expected credit losses arising after the measurement date.

As noted by the SEC staff, an entity may, but is not required to, include information relating to forecasting assumptions used in estimating expected credit losses that is known or knowable as of the measurement date. Therefore, an entity must develop a clear and consistent policy for assessing whether information related to forecasting assumptions received before the completion of an appropriate expected credit loss estimation process is known or knowable as of measurement date.

If information related to forecasting assumptions received after the entity has completed an appropriate estimation process, but before the financial statements are issued or available to be issued, indicates a weakness or deficiency in the entity's estimation process, the entity should recognize that information in its CECL estimation process.

Considering COVID-19

Impact on transition adjustments

Many entities adopting ASC 326 as of Jan. 1, 2020, will be finalizing their transition adjustments during the first quarter of 2020. These entities may be considering whether the impact of the pandemic should be incorporated in their opening balance-sheet retained earnings adjustment, or as a change in their estimate of expected credit losses during the first quarter of 2020.

Although the first known case of COVID-19 was reported to the World Health Organization on Dec. 31, 2019, the likelihood of a pandemic and its potential impact on the global economy were largely unknown. Therefore, we believe that the economic impact of the pandemic should not be considered in an entity's estimate of expected credit losses as of Jan. 1, 2020.

Subsequent CECL estimates

Entities estimating expected credit losses as of measurement dates subsequent to Jan. 1, 2020, should consider information related to the pandemic that was known or knowable as of that date. Such information may be included in the entity's forecasting assumptions used in estimating expected credit losses.

In light of the information on the pandemic that is known or knowable as of a subsequent measurement date, entities will need to evaluate the length of their reasonable and supportable forecast period. An entity may determine that the period over which it can reasonably and supportably forecast future conditions might be shorter due to the economic instability resulting from the pandemic.

Additionally, entities will also need to evaluate the pattern of reversion used in their estimation approach for financial assets whose contractual lives exceed the entity's reasonable and supportable forecast period. An entity should use a pattern of reversion that results in its best overall estimate of expected credit losses.

For more on the accounting impact of the COVID-19 pandemic, see New Developments Summary, "[COVID-19 impact on accounting, financial reporting.](#)"

Contacts



Graham Dyer
Partner
Accounting Principles Group
T +1 312.602.8107
E Graham.Dyer@us.gt.com



Rahul Gupta
Partner
Accounting Principles Group
T +1 312.602.8084
E Rahul.Gupta@us.gt.com

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