



# New Developments Summary

## Measuring credit losses on financial instruments

### ASU 2016-13 requires recognition of expected credit losses

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#### Summary

In June 2016 the FASB issued ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, which adds a new Topic 326 to the Codification and removes the thresholds that companies apply to measure credit losses on financial instruments measured at amortized cost, such as loans, receivables, and held-to-maturity debt securities. Under current U.S. GAAP, companies generally recognize credit losses when it is probable that the loss has been incurred. The revised guidance will remove all recognition thresholds and will require companies to recognize an allowance for credit losses for the difference between the amortized cost basis of a financial instrument and the amount of amortized cost that the company expects to collect over the instrument’s contractual life.

ASU 2016-13 also amends the credit loss measurement guidance for available-for-sale debt securities and beneficial interests in securitized financial assets. This bulletin summarizes the guidance in ASU 2016-13.

The guidance in ASU 2016-13 is effective for “public business entities,” as defined, that are SEC filers for fiscal years and for interim periods with those fiscal years beginning after December 15, 2019. For all other public business entities, the guidance is effective for fiscal years and for interim periods with those fiscal years beginning after December 15, 2020.

All other entities, including not-for-profit entities and employee benefit plans within the scope of ASC 960 through 965 on plan accounting, will be required to adopt the guidance in ASU 2016-13 for fiscal years beginning after December 15, 2020 and for interim periods within fiscal years beginning after December 15, 2021.

Early adoption of the guidance is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

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## A. Overview

With the issuance of ASU 2016-13, the FASB has completed the impairment section of its financial instruments project. Earlier in 2016 the FASB issued ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, completing the recognition and measurement section of the financial instruments project. The FASB is still deliberating on the final section of this project on hedge accounting and expects to issue a proposed ASU in the third quarter of 2016.

The guidance in ASU 2016-13 amends the following areas in U.S. GAAP, which are discussed in greater detail in this bulletin:

- An allowance for credit losses on financial instruments measured at amortized cost (such as loans, receivables, and held-to-maturity debt securities) will be measured as the difference between amortized cost and the amount of amortized cost that the entity expects to collect over the contractual life. The new guidance therefore eliminates all thresholds (such as probable or amortized cost being less than fair value) to recognize credit losses.
- The existing specific guidance on recognizing interest income and credit losses for loans and debt securities acquired with deteriorated credit quality in ASC 310-30, *Receivables: Loans and Debt Securities Acquired With Deteriorated Credit Quality*, is removed. Upon acquisition, the allowance for credit losses on such assets will be recognized by increasing the amortized cost balance by a corresponding amount rather than through a charge to the income statement. However, the subsequent measurement and recognition of interest income and allowance for credit losses will be similar to other financial assets that are carried at amortized cost.
- The credit loss recognition guidance for available-for-sale debt securities is amended and will require that credit losses on such debt securities should be recognized as an allowance for credit losses rather than a direct write-down of amortized cost balance.

- The guidance on measurement of credit losses on beneficial interests in securitized financial assets is amended to align with the new credit loss measurement guidance.
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## B. Credit losses on financial assets measured at amortized cost

### Scope

The financial assets that are not measured at fair value are within the scope of the new guidance on measuring expected credit losses, including the following assets:

- Financial assets measured at amortized cost, including financing receivables, held-to-maturity securities, receivables resulting from revenue transactions, and reinsurance receivables
- Net investment in leases recognized by lessors
- Off-balance sheet credit exposures (for example, loan commitments, standby letters of credit, financial guarantees) not accounted for as insurance

The following financial assets are excluded from the scope of the new expected credit loss measurement guidance:

- Loans made to participants by defined contribution employee benefit plans
- Policy loan receivables of an insurance entity
- Promises to give (pledges receivable) of a not-for-profit entity
- Loans and receivables between entities under common control.

### Initial measurement

The new guidance defines the allowance for credit losses to be the difference between the amortized cost balance of an in-scope financial asset and the amount of amortized cost that the entity expects to collect over the remaining contractual life. The process of measuring the allowance for credit losses can be divided into the following five steps:

Step 1: Pool the assets that share similar risk characteristics

Step 2: Identify appropriate loss measurement method for each pool

Step 3: Identify historical loss experience on each pool

Step 4: Adjust the historical loss experience to reflect current conditions and reasonable and supportable forecasts

Step 5: For periods for which a reasonable and supportable forecast cannot be made, revert to historical loss experience determined in step 3

#### ***Step 1: Pool assets that share similar risk characteristics***

For the purpose of measuring the allowance for credit losses, the new guidance requires that entities should pool assets that share similar risk characteristics, consistent with the entity's policies for monitoring credit risk. The guidance provides examples of risk characteristics that may be used to pool assets, such as vintage, term, industry, internal or external credit score or credit ratings, size, or geographical location. The assets that do not share risk characteristics with other assets held by the entity should be assessed for credit losses on an individual basis.

### Similar risk characteristics

The new expected credit loss model introduced in ASU 2016-13 is designed to provide financial statement users with information about management's expectations of lifetime credit losses by leveraging management's credit monitoring systems. Accordingly, when assessing whether financial assets share similar risk characteristics and should therefore be pooled together for the purpose of estimating expected credit losses, an entity must consider two criteria required to pool loans:

- First, the assets must share similar risk characteristics, such as those listed in ASC 326-20-55-4, *Financial Instruments – Credit Losses: Measured at Amortized Cost*.
- Second, assets should be pooled in a manner consistent with the entity's policies for monitoring credit risk.

Assets should not be pooled based on one set of risk characteristics for purposes of estimating expected credit losses and on another separate set of risk characteristics for credit risk monitoring.

### **Step 2: Identify appropriate loss measurement method for each pool**

The new guidance does not prescribe a specific method that entities should use to measure the allowance for credit losses. Entities should use judgment and may use a variety of methods, including discounted cash flow methods, loss rate methods, roll-rate methods, probability-of-default methods, or methods that utilize an aging schedule to calculate allowance. If an entity uses a discounted cash flow method, it should use the effective interest rate to discount the cash flows, and the allowance for credit losses determined using such method should reflect the difference between the amortized cost basis and the present value of expected cash flows.

An entity may also choose to measure the allowance for credit losses on the amortized cost balance or may choose to calculate the allowance on the unpaid principal balance and then adjust that allowance for other components of amortized cost balance, such as premiums and discounts (including net deferred fees and costs), foreign exchange, and fair value hedge accounting adjustments. These adjustments would either result in an increase or a decrease in the allowance for credit losses on unpaid principal balance based upon the entity's expectation of how much of these balances will be written off during the remaining contractual life.

### **Step 3: Identify historical loss experience on each pool**

The new guidance requires entities to estimate expected credit losses over the remaining contractual term of the financial asset. It prohibits entities from extending the contractual term for expected extensions, renewals, and modifications, unless it is reasonably possible at the reporting date that a troubled debt restructuring will be executed for the borrower.

Therefore, in order to estimate expected credit losses over the remaining contractual terms, the starting point of the estimate is the entity's historical loss experience on a similar pool of assets. The historical loss experience can be based on internal data (that is, the entity's own experience), on external data, or on a combination of both internal and external data. The new guidance does not specify the number of historical periods that the entity should consider. The guidance also states that the historical periods that

are considered in determining the historical loss experience may be those that represent management's expectation of future credit losses, or they may be other periods. Further, the guidance states that the historical credit loss experience may need to be adjusted for differences in the current pool's specific risk characteristics, which may be different when compared to the historical pool on which the historical loss experience is based. Such differences may arise due to the differences in underwriting standards, portfolio mix, or asset term.

***Step 4: Adjust the historical loss experience to reflect current conditions and reasonable and supportable forecasts***

Once the entity has determined the historical credit loss experience (adjusted for differences on the asset-specific risk characteristics), it should adjust the historical credit loss experience for current conditions and for reasonable and supportable forecasts to reflect management's expectations for credit losses on the financial assets. These adjustments would generally be qualitative in nature and should reflect changes in relevant data, such as unemployment rates, property values, commodity values, delinquency, or other factors that are associated with credit losses on financial assets. The guidance does not prescribe the length of time over which the reasonable and supportable forecasts should be developed.

***Step 5: For periods for which a reasonable and supportable forecast cannot be made, revert to historical loss experience determined in Step 3***

Since the entity is not required to develop a forecast of credit loss for periods for which such forecast cannot be reasonably and supportably developed, the new guidance requires entities to revert to the historical loss experience (as discussed in Step 3 above) for the remaining contractual period beyond the reasonable and supportable forecast. Again, the guidance does not prescribe a specific reversion method and allows entities to revert on a rational and systematic basis, including immediately or on a straight-line basis. The guidance also allows an entity to revert for each input in its estimation method separately or for the entire estimate.

***Application to off-balance sheet credit exposure***

For off-balance sheet credit risk exposures that are not unconditionally cancelable by the lender, expected credit losses will be estimated using the same five-step process discussed above over the contractual term. The credit losses for off-balance sheet credit exposure will be recorded as a liability in the balance sheet. For off-balance sheet credit exposures that are unconditionally cancelable by the lender, such as most undrawn credit card commitments, no credit loss estimate will be made until the borrower draws on the commitment.

***Application to purchased financial assets with credit deterioration***

The guidance in ASU 2016-13 removes the guidance in ASC 310-30 to account for loans and debt securities acquired with deteriorated credit quality and instead requires such financial assets to be accounted for, subsequent to initial recognition, similarly to any other financial assets in the scope of the new guidance. The new guidance does, however, provide different initial measurement and recognition guidance for credit losses on purchased financial assets with credit deterioration (PCD assets). It also expands the scope of the financial assets that will qualify as PCD assets and defines such financial assets as those that have experienced, as of the date of acquisition, a more-than-insignificant credit deterioration in credit quality since origination, as determined by the acquirer's assessment.

For the financial assets that meet the definition of PCD assets, the guidance requires that upon initial recognition, the allowance for credit losses should be recorded by increasing the purchase price to arrive

at the initial amortized cost basis. It also requires that the initial measurement of allowance for credit losses on such assets should be based on the unpaid principal balance if the entity uses a method that does not use a discounted cash flow approach. If the entity uses a discounted cash flow approach to calculate the initial allowance for credit losses on such assets, then the effective interest rate on such assets would be equal to the rate that equates the present value of estimated future cash flows with the purchase price. The guidance further requires that if determined on a collective basis, the allowance for credit losses and noncredit discount or premium should be allocated to individual assets for initial measurement purposes.

## Subsequent measurement

The new guidance requires that at each subsequent reporting period, an entity will estimate its allowance for credit losses using the five steps mentioned above and will report any increase or decrease in the allowance in net income as either a credit loss expense or a reversal of credit loss expense.

### ***Financial assets secured by collateral***

#### Collateral-dependent financial assets

For financial assets on which repayment is expected to be provided substantially through the operation or sale of the underlying collateral due to the borrower's financial difficulty, the guidance allows an entity the option to measure the allowance for credit losses as the difference between the fair value of the collateral and the amortized cost of the financial asset. Fair value will be reduced by the cost to sell the underlying collateral if the repayment is expected from selling the underlying collateral. If, however, the repayment is expected to be received from operating the underlying collateral, any estimated cost to sell the collateral will not be deducted from the fair value.

The guidance additionally requires that if foreclosure is probable, the entity should use the fair value of the collateral to measure the allowance for credit loss.

### ***Loans subsequently identified for sale***

The allowance for credit loss on loans (both mortgage and nonmortgage) that are classified as held-for-sale by an entity will be measured as the amount by which the loan's amortized costs basis exceeds the fair value.

## Disclosures

The guidance in ASU 2016-13 carries forward many of the same disclosures that are required under current U.S. GAAP. The guidance requires entities to disclose information about the credit quality (discussed below), the allowance for credit losses, past-due status, nonaccrual status, purchased financial assets with credit deterioration, collateral-dependent financial assets, and off-balance sheet credit exposures.

The guidance provides objectives for the disclosures about credit losses and states that the disclosures should enable a financial statement user to understand the following about the credit risk:

- The credit risk inherent in a portfolio and how management monitors the credit quality of the portfolio
- Management's estimate of expected credit losses
- Changes in the estimate of expected credit losses that have taken place during the period

Consistent with current U.S. GAAP, the guidance continues to allow entities to provide disclosures by either portfolio segments or by class of financing receivable (by major security type for held-to-maturity

securities). The guidance also carries forward the implementation guidance in current U.S. GAAP to determine portfolio segments, class of financing receivable, and major security type.

### ***Credit quality information***

The guidance in ASU 2016-13 retains the disclosures about credit quality information that are currently required and expands the scope of those disclosures to apply to both financing receivables and held-to-maturity securities. The guidance excludes the following types of financial instruments from the scope of the credit quality disclosure requirements:

- Off-balance sheet credit exposure
- Repurchase agreements and securities lending arrangements
- Receivables measured at lower of amortized cost basis and fair value (such as loans held-for-sale)
- Trade receivables due in one year or less that result from revenue transactions (except credit card receivables)

The new guidance further amends the credit quality information disclosure requirements, which currently require an entity to disclose the following information:

- A description of the credit quality indicator(s)
- The amortized cost basis for each credit quality indicator
- The date or range of dates when the information for each credit quality indicator was updated

The new guidance will require public business entities to provide the amortized cost basis on a disaggregated basis by year of origination for the past five annual reporting periods, with the amortized cost basis for years prior to the fifth annual reporting period presented as a total. Such disaggregation, however, will not be required for reinsurance receivables and for funded and unfunded line-of-credit arrangements. Refer to the Appendix for an example of the disclosure requirements that are included in ASU 2016-13. Even though not required in the guidance, the disclosure example included in ASU 2016-13 requires entities to also disclose the gross amount of write-offs and recoveries by year of origination.

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## **Credit losses on available-for-sale debt securities**

The guidance in ASU 2016-13 amends the other-than-temporary impairment guidance for measuring credit losses on available-for-sale (AFS) securities, but it retains the threshold for recognizing the credit loss on AFS securities. That threshold is met when the fair value of the AFS security is less than its amortized cost. The guidance also continues to require AFS securities to be assessed individually for credit losses, consistent with current U.S. GAAP. The guidance requires, however, that any credit loss on an AFS security be recognized through an allowance for credit loss rather than through direct write off of amortized cost basis, as required in current U.S. GAAP. Therefore, any subsequent improvements in credit will be recognized in income via a reversal of the allowance for credit losses in the period in which they occur.

The initial allowance for credit losses for purchased available-for-sale securities with a more-than-insignificant amount of credit deterioration will be recognized similarly to a PCD asset by debiting the purchase price.

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## Credit losses on beneficial interests in securitized financial assets

The guidance in ASU 2016-13 conforms the impairment guidance for beneficial interests that are not of high credit quality in ASC 325-40, *Investments – Other: Beneficial Interests in Securitized Financial Assets*, to the new credit loss guidance for held-to-maturity securities and available-for-sale debt securities. Therefore, an entity holding a beneficial interest in securitized financial assets will apply the credit loss guidance for held-to-maturity securities for those beneficial interests classified as held-to-maturity and for available-for-sale securities for those classified as available-for-sale.

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## Transition

Entities will apply the new guidance as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is adopted. The following specific transition provisions are included in the guidance:

- The guidance for purchased financial assets with credit deterioration will be applied prospectively to financial assets that are accounted for under ASC 310-30 as of the date of adoption.
  - The guidance in ASU 2016-13 will be applied prospectively to debt securities with an other-than-temporary impairment that has been recognized before the date of adoption. Therefore, the amortized cost basis of such debt securities will not change as a result of adoption of the guidance. In addition, any amounts recognized in other comprehensive income prior to the date of adoption of the new guidance due to the improvements in cash flow on such debt securities will continue to be accreted to income over the remaining life of the debt security on a level-yield basis.
  - Public business entities that are not SEC filers can adopt the disaggregated credit quality information disclosure requirements in a phased manner by only presenting the prior three years of originations in the year of adoption and then increasing the disclosure for one fiscal year in each year subsequent to the fiscal year of adoption until it reaches five years of disclosures.
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## Effective date

The guidance in ASU 2016-19 is effective as follows:

- *For public business entities that are SEC filers:* Fiscal years beginning after December 15, 2019, including interim periods within those fiscal years
- *For other public business entities:* Fiscal years beginning after December 15, 2020, including interim periods within those fiscal years
- *For all other entities, including not-for-profit entities and employee benefit plans:* Fiscal years beginning after December 15, 2020 and interim periods within fiscal years beginning after December 15, 2021

Early adoption of the guidance is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

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