Grant Thornton

New Developments Summary

Codification improvements to the CECL model

ASU 2019-04 and 2019-11 introduce key changes to ASC 326

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Contents

The amendments in ASU 2019-04 and ASU 2019-11 make several key changes to the credit losses guidance originally issued in ASU 2016-13, including

- Accounting for accrued interest
- Accounting for transfers between classifications or categories of loans or debt securities
- Recognizing expected recoveries in the allowance for credit losses
- Determining the discount rate when using a discounted cash flow method to estimate the allowance for credit losses
- Providing vintage disclosures

Reporting entities should adopt the amendments in ASUs 2019-04 and 2019-11 when they adopt the guidance in ASU 2016-13.

A. FASB's financial instruments project

ASU 2019-04, *Codification Improvements to Topic 326, Financial Instruments – Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*, made certain changes to guidance previously issued as part of the FASB's broad project on financial instruments. That project has three main components:

1. *Classification and measurement of financial instruments* – This phase of the project resulted in the issuance of ASU 2016-01, which introduced Topic 321, *Equity Securities,* to the Codification. For more on ASU 2016-01, see Grant Thornton's NDSs 2016-03 and 2018-04.

2. *Credit losses* – This phase of the project resulted in the issuance of ASU 2016-13, which introduced the current expected credit losses (CECL) model. The CECL model applies to financial instruments measured at amortized cost. ASU 2016-13 also amended the impairment guidance in ASC 320, *Investments – Debt and Equity Securities*, applicable to available-for-sale debt securities. For more on ASU 2016-13, see Grant Thornton's NDS 2016-10.

   Additionally, to assist with the implementation of the CECL model, the FASB instituted the Transition Resource Group for Credit Losses (TRG), which has held four public meetings. For summaries of those meetings, see Grant Thornton's NDSs 2017-07, 2018-08, and 2018-15.

3. *Derivatives and hedging* – This phase of the project resulted in the issuance of ASU 2017-12, which provided targeted improvements to the guidance in ASC 815, *Derivatives and Hedging*. For more on ASU 2017-12, see Grant Thornton's NDS 2017-08.

While ASU 2019-04 impacts all three components of the FASB's project on financial instruments, this NDS focuses only on how the amendments impact the existing guidance on measuring credit losses. ASU 2019-11, *Codification Improvements to Topic 326, Financial Instruments – Credit Losses,* which made certain changes solely to the guidance on measuring credit losses, is summarized in this NDS.

B. Amendments: matters discussed by the TRG

Included in ASUs 2019-04 and 2019-11 are several amendments to ASC 326 that relate to issues discussed by the TRG at its meetings in June and November 2018, which are discussed below.

Accounting for accrued interest

In the Codification's Master Glossary, the definition of the "amortized cost basis" of a financial asset includes accrued interest.

> **Amortized Cost Basis**
>
> The amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion, or amortization of premium, discount, and net deferred fees or costs, collection of cash, writeoffs, foreign exchange, and fair value hedge accounting adjustments.

The allowance for credit losses (ACL) is applied to the amortized cost basis of the financial assets to result in a balance-sheet presentation of the net amount expected to be collected. Therefore, accrued interest that is not expected to be collected should be included in the ACL. However, the accounting for

uncollectible accrued interest under ASC 310-10, *Receivables,* and ASC 320, *Investments – Debt and Equity Securities,* is currently mixed in practice. Today, some entities measure the allowance for loan losses on the accrued interest balance, while others exclude the accrued interest when estimating the allowance for loan losses and instead account for uncollectible interest through a charge to interest income.

In June 2018, the TRG discussed whether the guidance in ASC 326 should change current practice regarding the accounting for accrued interest that is uncollectible. The TRG generally agreed with the FASB staff's recommendation to amend the guidance in ASC 326 to provide entities with a set of integrated accounting policy elections and practical expedients that would limit changes to current practice on accounting for uncollectible accrued interest in certain circumstances. ASUs 2019-04 and 2019-11 introduce the following accounting policy elections and practical expedients related to accounting for accrued interest.

Election not to measure ACL on accrued interest

An entity may make an accounting policy election not to measure the ACL on accrued interest associated with each class of financing receivable or major security type if the entity writes off the uncollectible accrued interest balance in a "timely" manner. An entity may not analogize this guidance to components of amortized cost other than accrued interest.

However, the amended guidance does not define what constitutes a "timely" manner. In Paragraph 20 of the Basis for Conclusion (BC20) of ASU 2019-04, the FASB indicates that entities will need to apply judgment based on the specific facts and circumstances to determine whether their policy for writing off uncollectible accrued interest is considered "timely."

An entity electing to exclude accrued interest from the ACL estimate must disclose that accounting policy election and the write-off policy under the amendments.

Grant Thornton insights: Assessing whether write-offs are timely

While the FASB intends to provide entities with flexibility in setting their write-off accounting policies when electing not to measure an ACL, the Board also believes that a timely write-off policy is a prerequisite for excluding accrued interest balances from the estimate of the ACL.

We believe that entities should consider several factors when assessing whether their policies and practices result in writing off uncollectible accrued interest in a timely manner, including

- The type of financial asset
- Industry practices
- Relevant regulatory guidelines
- The entity's operational credit risk management practices

Election to present accrued interest separately

An entity may make an accounting policy election to present accrued interest balances on the balance sheet separately from the other components of amortized cost of the underlying financial assets for each class of financing receivable or major security type. If an entity elects to present accrued interest separately, the accrued interest balance should be presented net of any associated ACL. An entity that chooses this election may present accrued interest in another line item on the balance sheet, such as in Other Assets.

If an entity elects to separately present accrued interest in another line item on the balance sheet, it must disclose the line item where the accrued interest is presented, the amount of accrued interest, and any associated ACL.

Election regarding writing off accrued interest

Although there is currently diversity in practice regarding how entities account for write-offs of uncollectible amounts of accrued interest receivables, the FASB concluded that it does not intend to change the practice in this area. Accordingly, an entity may make an accounting policy election to write off uncollectible accrued interest for each major class of financing receivable or major security type in one of three ways:

- By recognizing credit loss expense
- By reversing interest income
- By using a combination of both

This accounting policy election is separate from the election not to estimate an ACL for accrued interest receivable balances if the balances are written off in a timely manner. Additionally, an entity may not analogize this guidance to components of amortized cost other than accrued interest.

The guidance in ASU 2019-04 requires entities to disclose their accounting policy election regarding the treatment of uncollectible accrued interest, as well as the amount of accrued interest reversed through interest income by portfolio segment or major security type.

Practical expedient for disclosures related to accrued interest

If an entity does not elect to present accrued interest balances separately on the balance sheet from the other components of amortized cost of the underlying financial assets, then it may, as a practical expedient, exclude the accrued interest balance from the disclosure requirements in ASC 326-20-50-4 through 50-22 and in ASC 320-10-50-2 and 50-5. If an entity applies this practical expedient, it must disclose the total amount of accrued interest receivable, net of the ACL (if any), that has been excluded from these disclosures.

Separately measure the ACL on accrued interest

An entity may estimate the ACL separately for certain components of the amortized cost of its financial assets when using an estimation method other than a discounted cash flow approach. Specifically, an entity may separately estimate the ACL for

- Premium or discounts, including net deferred fees and costs, foreign exchange, and fair-value hedge accounting adjustments

- Applicable accrued interest
- The face amount or unpaid principal balance

Grant Thornton insights: Pooling accrued interest receivable balances

The guidance in ASC 326 requires financial assets to be pooled based on similar risk characteristics. We believe this requirement applies to accrued interest receivable balances for which an entity separately estimates the ACL.

In June 2018, certain TRG members noted that while an entity may estimate the ACL on the accrued interest receivable separately from the other components of amortized cost of the underlying financial asset, the risk characteristics of an accrued interest receivable balance may be linked to the underlying financial asset that gave rise to the accrued interest receivable balance. As a result, entities should consider whether the risk characteristics of accrued interest balances are linked to the underlying financial asset when pooling accrued interest receivable balances with similar risk characteristics. This may result in pooling accrued interest on the same basis as the underlying financial assets that gave rise to the accrued interest.

Transfers between classification or categories

Debt securities may be classified as trading, available-for-sale, or held-to-maturity, while loans may be categorized as either held-for-sale or held-for-investment. ASU 2016-13 did not provide guidance on how the relevant impairment guidance should be applied when loans and debt securities are transferred between measurement classifications or categories.

Grant Thornton insights: Applying the PCD model upon a transfer to held-for-investment or held-to-maturity

The purchased credit deteriorated (PCD) guidance applies only upon the initial recognition of a financial asset. Accordingly, an entity should not apply the PCD guidance to a loan transferred into the held-for-investment classification or a debt security transferred to the held-to-maturity category, regardless of whether the loan or debt security has experienced a more than insignificant deterioration in credit quality since origination.

Available-for-sale debt securities are currently measured at fair value under the guidance in ASC 320. Credit losses on impaired available-for-sale debt securities are currently recognized through an ACL according to the guidance in ASC 326-30. Credit losses recognized on an available-for-sale debt security are subject to a fair value “floor,” meaning that the ACL should not reduce the net carrying amount of the available-for-sale debt security below its fair value. Any changes in fair value unrelated to credit are recognized as an unrealized gain or loss in other comprehensive income (OCI).

In addition, held-for-sale loans are measured at the lower of cost or fair value, subject to a valuation allowance. The valuation allowance for held-for-sale loans, however, does not distinguish between changes in fair value due to credit and those due to other reasons.

Held-to-maturity debt securities and held-for-investment loans are both measured at amortized cost and therefore fall within the scope of the CECL guidance in ASC 326.

As noted above, ASU 2016-13 did not provide guidance on how the relevant impairment guidance should be applied when loans and debt securities are transferred between measurement classifications or categories. ASU 2019-04 introduces guidance that requires an entity to first reverse any ACL or valuation allowance on a loan or debt security existing as of the date of transfer through earnings, to reclassify and transfer the loan or debt security at amortized cost, and then to apply the measurement guidance applicable to the new category or classification.

Grant Thornton insights: Determining amounts to reverse in earnings

The CECL model generally requires an entity to estimate the ACL on the basis of a pool of financial assets with similar risk characteristics that are measured at amortized cost. However, when a loan or group of loans is transferred to the held-for-sale classification from the held-for-investment classification, an entity must reverse in earnings any ACL recorded only on the transferred loan or group of loans. Because the loan or group of loans transferred may be a subset of a held-for-investment pool that was previously used to estimate the ACL, an entity's typical process for estimating the ACL may not provide sufficient granularity to determine the amount of ACL to reverse in earnings upon the transfer.

Additionally, the guidance regarding transfers of loans between classifications introduced by ASU 2019-04 applies as of the transfer date, which may not align with a financial reporting date for which the entity has estimated either the fair value of loans held-for-sale or the ACL for loans held-for-investment.

Due to these issues, determining the amount of the ACL or valuation allowance attributable to a transferred loan or group of loans as of the transfer date will be challenging for many entities. Entities should use judgment to develop processes and procedures that are appropriate in their circumstances, and that can be consistently applied, to estimate the ACL or valuation allowance for a transferred loan as of the transfer date.

Transferring loans between held-for-sale and held-for-investment categories

When a loan is transferred to the held-for-sale classification from the held-for-investment classification, an entity is required, at the transfer date, to reverse in earnings any ACL previously recorded on the loan and then to reclassify and transfer the loan into the held-for-sale classification at amortized cost (which is reduced by write-offs but excludes any ACL). An entity must then determine if a valuation allowance is necessary in order to carry the held-for-sale loan at the lower of cost or fair value in accordance with the guidance in ASC 310-10.

Transferring a loan to held-for-sale from held-for-investment

On 1/1/X1, Entity A concludes that it intends to sell one of its loan receivables. At the transfer date, the loan has a carrying amount of $850,000, which consists of the following amounts:

- Unpaid principal balance: $1,000,000
- Discount: $100,000
- ACL: $50,000

Entity A estimates the loan's fair value at the transfer date to be $875,000. Accordingly, Entity A will record the following journal entries pursuant to the transfer:

To reverse the ACL in income

Dr – ACL: $50,000

Cr – Credit Loss Expense: $50,000

To record valuation allowance

Dr – Fair-value adjustment expense: $25,000

Cr – Valuation allowance: $25,000

After the transfer, the loan has a carrying amount of $875,000, which is comprised of the following amounts:

- Unpaid principal balance: $1,000,000
- Discount: $100,000
- Valuation allowance: $25,000

Similarly, when a loan is transferred to the held-for-investment classification from the held-for-sale classification, an entity is required, at the transfer date, to reverse in earnings any valuation allowance previously recorded on the loan, and then to reclassify and transfer the loan into held-for-investment classification at amortized cost (which is reduced by write-offs but excludes any ACL). An entity must then determine if an ACL is necessary under the CECL model.

Transferring a loan to held-for-investment from held-for-sale

On 1/1/X1, Entity A concludes that it no longer intends to sell one of its loan receivables previously classified as held-for-sale, and therefore transfers the loan into the held-for-investment classification. At the transfer date, the loan's fair value and carrying amount is $875,000, which is comprised of the following components:

- Unpaid principal balance: $1,000,000

- Discount: $100,000
- Valuation allowance: $25,000

Entity A estimates the expected credit loss associated with the transferred loan to be $50,000 at the transfer date.

Accordingly, Entity A will record the following journal entries pursuant to the transfer:

To reverse the valuation allowance in income

Dr – Valuation allowance: $25,000

Cr – Fair-value adjustment expense: $25,000

To record the ACL

Dr – Credit loss expense: $50,000

Cr – ACL: $50,000

After the transfer, the loan has a carrying amount of $850,000, which is comprised of the following amounts:

- Unpaid principal balance: $1,000,000
- Discount: $100,000
- ACL: $50,000

Transferring debt securities between available-for-sale and held-to-maturity

When a debt security is transferred to available-for-sale from held-to-maturity, an entity is required, at the transfer date, to reverse in earnings any ACL previously recorded on the debt security, and then to reclassify and transfer the debt security into the available-for-sale category at amortized cost (which is reduced by write-offs but excludes any ACL). The entity must then estimate the fair value of the debt security and record any unrealized gain or loss in OCI, except for any unrealized loss recorded in ACL pursuant to the guidance in ASC 326-30. Importantly, an entity that transfers debt securities from held-to-maturity to available-for-sale should consider the guidance in ASC 320-10-35-8 and 35-9 regarding whether the transfer calls into question the entity's intent and ability to hold to term securities that remain in the held-to-maturity category.

Transferring a debt security to available-for-sale from held-to-maturity

On 1/1/X1, Entity A determines that it no longer has the intent and ability to hold a debt security to maturity and, accordingly, transfers that security from the held-to-maturity category to the available-for-sale category. At the transfer date, the debt security has a carrying amount of $885,000, which is composed of the following amounts:

- Par amount: $1,000,000

- Discount: $100,000
- ACL: $15,000

Entity A estimates the debt security's fair value at the transfer date to be $875,000. Of the $25,000 difference between the debt security's amortized cost basis and fair value, Entity A estimates that $15,000 represents a credit loss. Accordingly, Entity A records the following journal entries pursuant to the transfer:

To reverse the ACL in income

Dr – ACL: $15,000

Cr – Credit loss expense: $15,000

To record the unrealized loss

Dr – OCI: $10,000

Cr – Valuation allowance for unrealized loss not attributable to credit: $10,000

Dr – Credit loss expense: $15,000

Cr – ACL: $15,000

After the transfer, the debt security has a carrying amount of $875,000, which is comprised of the following amounts:

- Par amount: $1,000,000
- Discount: $100,000
- Valuation allowance for unrealized loss not attributable to credit (with a corresponding balance in OCI): $10,000
- ACL: $15,000

Similarly, when a debt security is transferred to held-to-maturity from available-for-sale, an entity is required, at the transfer date, to reverse in earnings any ACL previously recorded on the debt security, and then to reclassify and transfer the security into the held-to-maturity category at amortized cost (which is reduced by write-offs and excludes any ACL). Additionally, the amortized cost basis of the debt security at the date of transfer is adjusted (by creating a discount or premium) for any unrealized gains or losses previously recognized in OCI. Any unrealized gains and losses in OCI at the date of the transfer cannot be reversed, but rather are amortized as an adjustment to yield in a manner consistent with the amortization of any premium or discount.

Transferring a debt security to held-for-maturity from available-for-sale

On 1/1/X1, Entity A determines that it has the intent and ability to hold an available-for-sale debt security to maturity and transfers the debt security from available-for-sale to held-to-maturity. At the transfer date, the debt security's carrying amount (and also its fair value) is $875,000, which comprises the following components:

- Par: $1,000,000
- Discount: $100,000
- Valuation allowance for unrealized loss not attributable to credit: $10,000 (with a corresponding balance in OCI)
- ACL: $15,000

At the transfer date, Entity A estimates expected credit losses on the debt security are $15,000. Accordingly, Entity A records the following journal entries pursuant to the transfer:

To reverse the previously recognized ACL as of the transfer date

Dr – ACL: $15,000

Cr – Credit loss expense: $15,000

To reflect the transfer from available-for-sale to held-to-maturity

Dr – Valuation allowance for unrealized losses not attributable to credit: $10,000

Cr – Discount: $10,000

Dr – Credit loss expense: $15,000

Cr – ACL: $15,000

After the transfer, the debt security has a carrying amount of $875,000, which is comprised of the following amounts:

- Par amount: $1,000,000
- Discount: $110,000
- ACL: $15,000

After the transfer date, the remaining $10,000 amount in OCI is amortized as an offset to interest income in the same manner as the debt security's discount.

Recoveries

Under the CECL model, an entity is required to estimate an ACL that results in the entity presenting its financial assets measured at amortized cost on the balance sheet at the net amount expected to be collected. The amendments in ASUs 2019-04 and 2019-11 clarify that an entity should consider expected

recoveries when estimating the ACL. These amendments are a significant change from current U.S. GAAP, which treats recoveries as gain contingencies by generally prohibiting entities from recognizing recoveries of amounts previously written off until collected.

Grant Thornton insights: Estimating recoveries is not optional

Under the amendments in ASUs 2019-04 and 2019-11, recoveries are an essential component in estimating the ACL. An entity must have a process in place for estimating expected future recoveries, without incurring undue cost or effort. That is, an entity must undertake a reasonable effort to affirmatively conclude whether it reasonably expects future recoveries of amounts of financial assets measured at amortized cost that were previously written off. This principle is illustrated by Example 9 in ASC 326-20.

Example 9: Recognizing Writeoffs and Recoveries

ASC 326-20-55-52

Bank K currently evaluates its loan to Entity L on an individual basis because Entity L is 90 days past due on its loan payments and the loan no longer exhibits similar risk characteristics with other loans in the portfolio. At the end of December 31, 20X3, the amortized cost basis for Entity L's loan is $500,000 with an allowance for credit losses of $375,000. During the first quarter of 20X4, Entity L issues a press release stating that it is filing for bankruptcy. Bank K determines that the $500,000 loan made to Entity L is uncollectible. Bank K considers all available information that is relevant and reasonably available, without undue cost or effort, and determines that the information does not support an expectation of a future recovery in accordance with paragraph 326-20-30-7. Bank K measures a full credit loss on the loan to Entity L and writes off its entire loan balance in accordance with paragraph 326-20-35-8 as follows:

Dr – Credit loss expense: $125,000

Cr – Allowance for credit losses: $125,000

Dr – Allowance for credit losses: $500,000

Cr – Loan receivable: $500,000

During March, 20X6, Bank K receives a partial payment of $50,000 from Entity L for the loan previously written off. Upon receipt of the payment, Bank K recognizes the recovery in accordance with paragraph 326-20-35-8 as follows:

Dr – Cash: $50,000

Cr – Allowance for credit losses (recovery): $50,000

Recoverable amounts to include in the estimate of the ACL

Under the amendments allowing entities to include recoveries in the ACL estimate, the ACL may be a "negative" amount—that is, it may result in a presentation on the balance sheet of an amount in excess of the amortized cost basis of an asset. However, recoverable amounts included in the estimate of the ACL may not exceed the aggregate of amounts previously written off and amounts expected to be written off by the entity, and a negative ACL may not exceed amounts previously written off.

The guidance in ASU 2019-11 further clarifies that when estimating ACL for PCD assets, if an entity uses a method other than a discounted cash flow method to estimate expected credit losses, expected recoveries should not include any amounts that result in an acceleration of the noncredit discount. In addition, the recoverable amounts included in the estimate of ACL for PCD assets may include increases in expected cash flows after acquisition. The application of the recoverable amount guidance on PCD assets is illustrated by Examples 18 and 19 in ASC 326-20.

Example 18: Determining the Negative Allowance for Purchased Financial Assets with Credit Deterioration with No Change in Credit Conditions

ASC 326-20-55-86

The following Example illustrates the application of the guidance in paragraph 326-20-30-13A for purchased financial assets with credit deterioration. For purposes of this Example, the acquired portfolio of loans is assumed to share similar risk characteristics and is evaluated for credit losses on a collective basis.

ASC 326-20-55-87

Bank Q purchases a portfolio of loans with a par amount of $10 million for $2 million. At acquisition, Bank Q expects to collect $2.5 million on the loan portfolio. Bank Q estimates expected credit losses using a method other than a discounted cash flow method in accordance with paragraph 326-20-30-4. The acquisition-date journal entry is as follows.

Dr – Loan – par amount:	$10,000,000	
Cr – Loan – noncredit discount:		$500,000
Cr – Allowance for credit losses:		$7,500,000
Cr – Cash:		$2,000,000

ASC 326-20-55-88

After acquisition, Bank Q determines that each loan is deemed uncollectible on an individual unit-of-account basis and, therefore, writes off the loan portfolio. The following journal entries are recorded.

Dr – Provision expense:	$2,000,000	
Cr – Allowance for credit losses:		$2,000,000
Dr – Allowance for credit losses:	$9,500,000	
Dr – Loan – noncredit discount:	$500,000	

Cr – Loan – par amount: $10,000,000

ASC 326-20-55-89

Although deemed uncollectible on an individual basis, when grouped together, the group of loans is expected to have some recoveries on an aggregate basis. Therefore, Bank Q records a negative allowance in accordance with paragraph 326-20-30-13A. Because Bank Q's expectation of credit conditions has not changed since acquisition, the expected recoveries of $2.5 million must not result in the acceleration of the noncredit discount that existed immediately before being written off. Therefore, the following journal entry is recorded.

Dr – Allowance for credit losses: $2,000,000

Cr – Provision expense: $2,000,000

Example 19: Determining the Negative Allowance for Purchased Financial Assets with Credit Deterioration after a Change in Credit Conditions

ASC 326-20-55-90

Assume the same facts from Example 18. Bank Q subsequently determines that a change in credit conditions has occurred and expects to collect an additional $600,000 (for a total of $3.1 million) on the group of loans. Because Bank Q's expectation of credit conditions has changed and it is determining the amount that it expects to collect using a method other than a discounted cash flow method, the expected recoveries of $3.1 million would be reduced by the noncredit discount of $0.5 million (that has not been accreted). This would result in Bank Q having an overall negative allowance of $2.6 million. Therefore, the following journal entry is recorded.

Dr – Allowance for credit losses: $600,000

Cr – Provision expense: $600,000

Grant Thornton insights: Negative ACL on collateral-dependent financial assets

An entity may use, as a practical expedient, the fair value of collateral at the reporting date to estimate the ACL for collateral-dependent financial assets. Collateral-dependent financial assets are financial assets whose underlying borrowers are experiencing financial difficulty at the reporting date and whose repayment is expected to be provided substantially through the operation or sale of the collateral securing the financial asset.

In some circumstances, the fair value of the collateral securing a collateral-dependent financial asset may exceed the amortized cost basis of a financial asset and any amounts previously written off. However, an entity is precluded from recognizing a negative ACL that exceeds amounts previously written off.

Negative ACL on collateral-dependent financial assets

Entity A owns a commercial mortgage loan classified as held-for-investment and secured by an office building. The borrower under the commercial mortgage loan is experiencing financial difficulty at the balance-sheet date, and Entity A determines that the commercial mortgage loan's repayment will be provided substantially through the sale of the office building. Accordingly, Entity A elects to estimate the ACL by using the fair value of the office building, less costs to sell.

At the measurement date, the commercial mortgage loan has a carrying amount of $7,000,000 comprised of the following amounts:

- Origination amount: $10,000,000
- Amounts written off: $3,000,000

Also, at the measurement date, Entity A estimates that the fair value of the office building, less costs to sell, is $10,500,000. In this case, Entity A would recognize a negative ACL of $3,000,000. Entity A would be precluded from recognizing a negative ACL of $3,500,000, because to do so would result in recognizing recoveries in excess of amounts previously written off.

Contractual extensions and renewals

The guidance in ASC 326-20 states that expected credit losses on financial assets should be estimated over the contractual life of the financial asset and that the contractual life should be extended only for reasonably expected troubled debt restructurings with a borrower. However, some financial assets contain contractual extension or renewal options. The amendments in ASU 2019-04 clarify that an entity should consider contractual extension or renewal options (excluding those that are accounted for as a derivative under ASC 815) when determining the contractual life of a financial asset, unless the contractual extension or renewal option is unconditionally cancellable.

Grant Thornton insights: Not an off-balance-sheet credit exposure

While contractual extension or renewal options that are not unconditionally cancellable may function similarly to undrawn lines of credit or other off-balance-sheet commitments, the extension and renewal options that are not unconditionally cancellable are not considered off-balance-sheet exposures. The FASB made clear in Paragraph BC130 of ASU 2019-04 that the original loan on which the extension or renewal option would be exercised is a recognized financial asset.

As a result, any incremental expected credit loss attributable to the portion of the contractual life of a financial assets associated with contractual extension or renewal options that are not unconditionally cancellable should be included in the ACL estimate as of the measurement date, and would not be classified as a separate liability associated with an off-balance-sheet credit exposure.

Under the amendments in ASU 2019-04, an entity must first consider whether the extension or renewal option is an embedded derivative that should be bifurcated in accordance with the guidance in ASC 815-15. If an entity concludes that the contractual extension or renewal option does not require bifurcation from the host financial asset, then it must consider the impact of the extension or renewal option on the contractual life of the host financial asset. The FASB did not prescribe a single method for determining the contractual term of a financial asset, but indicated in BC129-130 of ASU 2019-04 that an entity must consider the likelihood that the contractual extension or renewal option will be exercised.

Grant Thornton insights: Determining the impact of extensions and renewals

One acceptable method for determining the contractual life of a financial asset with contractual extension or renewal options that are not unconditionally cancellable by the lender is to calculate the product of (a) the likelihood of an extension being exercised, and (b) the expected credit losses over the extended contractual period. This method would be similar to the process described in ASC 326-20-30-11 for off-balance-sheet exposures on lines of credit that are not unconditionally cancellable by the lender. Other methods may also be acceptable.

In November 2018, the TRG discussed another potential method to determine the contractual life of a financial asset with contractual extension or renewal options that are not unconditionally cancellable by the lender. Under this method, an entity may assume that all contractual extensions will be exercised to determine the maximum contractual life, and then consider expected prepayments in a manner consistent with the guidance in ASC 326-20-30-6.

Vintage disclosures

The guidance in ASC 326 requires public business entities to disclose the amortized cost basis of financial assets by class of financing receivable or major security type, credit quality indicator, and year of origination. However, lines of credit are not distinguished by year of origination.

The amendments in ASU 2019-04 now require an entity to present the amortized cost basis of line-of-credit arrangements that are converted to term loans in a separate column in the vintage disclosure table.

See the attached appendix for the revised example vintage disclosure table.

C. Other clarifications

ASU 2019-04 also clarifies other guidance previously issued in ASU 2016-13, as discussed below.

Determining the effective interest rate in a discounted cash flow approach

The guidance in ASC 326 permits an entity to utilize a variety of approaches when estimating expected credit losses, including a discounted cash flow approach. If an entity elects to utilize a discounted cash flow approach, the ACL represents the difference between the amortized cost of the financial instrument and the present value of future cash flows expected on a financial instrument discounted at the financial instrument's "effective interest rate," as defined in the Master Glossary.

Effective Interest Rate

The rate of return implicit in the financial asset, that is, the contractual interest rate adjusted for any net deferred fees or costs, premium, or discount existing at the origination or acquisition of the financial asset. For purchased financial assets with credit deterioration, however, to decouple interest income from credit loss recognition, the premium or discount at acquisition excludes the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at the date of acquisition.

An entity may use certain assumptions in developing its estimate of future expected cash flows on a financial instrument that may give rise to a difference between the present value of future expected cash flows and the amortized cost of a financial asset that is not attributable to credit. ASU 2019-04 amends the guidance in ASC 326 to address these issues.

Projections of interest rate environments for variable-rate financial instruments

An entity may project future interest rate environments when making its estimate of future cash flows expected on a financial asset. However, the guidance in ASC 326 prohibits an entity from projecting future interest rate environments when determining the effective interest rate. Using an effective interest rate that is not adjusted for future interest rate environments to discount expected cash flows adjusted for future interest rate environments would give rise to a non-credit-related difference between the present value of future expected cash flows and the amortized cost that would be captured by the ALC.

ASU 2019-04 removes the prohibition in ASC 326 against estimating future interest rate environments when determining the effective interest rate. While the amendments do not require an entity to project changes in future interest rate environments for purposes of estimating expected future cash flows, the entity should use the same projections in determining the effective interest rate used to discount those cash flows if it projects changes in future interest rate environments for purposes of estimating expected future cash flows.

Grant Thornton insights: Impact on determination of interest income

The amendments in ASU 2019-04 on determining expected cash flows and the related effective interest rate for purposes of utilizing a discounted cash flow method for estimating the ACL do not impact the guidance applicable to a financial asset for recognizing interest income.

Consideration of prepayments in determining the effective interest rate

If an entity chooses to utilize a discounted cash flow approach to estimate expected credit losses, the guidance in ASC 326 requires the entity to adjust its estimate of future cash flows for expected prepayments. However, the determination of the effective interest rate does not generally allow a similar adjustment for expected prepayments. Discounting prepayment-adjusted cash flows using an effective interest rate that is not similarly adjusted for expected prepayment would give rise to a non-credit-related difference between the present value of future expected cash flows and the amortized cost, and that difference would be captured by the ALC.

The amendments in ASU 2019-04 permit an entity to make an accounting policy election for each class of financing receivable or major security type to adjust the effective interest rate used to discount the expected cash flows of a financial asset for the timing (and changes in timing) of expected prepayments.

Grant Thornton insights: Impact of prepayments on determination of interest income

While an entity may elect to use a prepayment-adjusted effective interest rate for estimating the ACL when utilizing a discounted cash flow approach, the amendments in ASU 2019-04 do not impact the determination of the effective interest rate for purposes of recognizing interest income.

Accordingly, expected prepayments would impact the effective interest rate used to recognize interest only for assets within the scope of the guidance in ASC 310-20-35-26 through 35-33, *Receivables: Nonrefundable Fees or Other Costs,* or in ASC 325-40, *Investments – Other: Beneficial Interests in Securitized Financial Assets.*

Determining prepayment-adjusted effective interest rate for a financial asset subject to TDR prior to effective date of ASU 2016-13

The improvements resulting from ASU 2019-11 amend the transition guidance in ASU 2016-13 by permitting an entity to make an accounting policy election to calculate the prepayment-adjusted effective interest rate for financial assets that had a troubled-debt restructuring (TDR) prior to the date of adopting the guidance in ASU 2016-13. Under this election, an entity should use the original contractual rate and prepayment assumptions as of the date of adopting ASU 2016-13, instead of using the prepayment-adjusted effective interest rate immediately before the financial asset's restructuring date, when calculating the prepayment-adjusted effective interest rate to be used in a discounted cash flow method for estimating expected credit losses.

Consideration of estimated costs to sell when foreclosure is probable

The amendments in ASU 2019-04 revise the existing guidance regarding the consideration of estimated costs to sell collateral securing a financial asset when foreclosure is probable. Specifically, the amendments state that an entity should adjust the fair value of the collateral in these circumstances for estimated costs if the entity intends to sell, rather than operate, the collateral. Additionally, the amendments state that an entity must estimate the costs to sell on an undiscounted basis.

Financial assets secured by collateral maintenance provisions

The guidance in ASC 326-20-35-6 provides a practical expedient to estimate the expected credit loss on financial assets secured by collateral maintenance provisions by comparing the amortized cost basis of a financial asset and the fair value of collateral securing the financial asset as of the reporting date. Amendments to this practical expedient in ASU 2019-11 clarify the following guidance:

- The practical expedient may be applied only if the entity *reasonably expects* the borrower will be able to continually replenish the collateral securing the financial asset. In determining whether to apply the practical expedient, an entity is neither required to consider *remote* scenarios nor to determine that it is *probable* the borrower will be able to continually replenish the collateral.

- When applying the practical expedient, an entity should estimate expected credit losses for any difference between the amount of the amortized cost basis that is greater than the fair value of the collateral securing the financial asset (that is, the unsecured portion of the amortized cost basis) in accordance with how it measures current expected credit loss for financial assets that do not qualify for any practical expedients. However the allowance should be limited to the unsecured portion of the amortized cost basis.

Financial assets secured by collateral maintenance provisions

Entity D previously loaned $1 million to Entity F. The loan from Entity D to Entity F is secured by a collateral maintenance provision, whereby Entity F must ensure that marketable securities are placed in an escrow account whose aggregate value is between 98 percent and 102 percent of the outstanding principal balance of the loan. The securities are revalued daily.

Entity D determines that it reasonably expects Entity F will be able to replenish the collateral securing the loan, and elects to apply the practical expedient in ASC 326-20-35-6.

At 6/30/X1, the amortized cost basis of the loan is $1 million, and the fair value of collateral securing the financial asset is $990,000 (99 percent of $1 million). Accordingly, Entity D estimates the ACL on the difference between the amortized cost basis of the financial asset and the fair value of the collateral, or $10,000, in accordance with how it measures credit losses on other similar financial assets that do not qualify for the practical expedient. The total allowance for credit losses may not exceed $10,000.

In this case, Entity D estimates credit losses on similar financial assets that do not qualify for the practical expedient in ASC 326-20-35-6 by estimating the assets' probability of default and loss given default based on historical losses for similar financial assets, adjusted for reasonable and supportable forecasts of future conditions. In this case, Entity D estimates that the probability of default for the loan to Entity F is 50 percent and the loss given default is 80 percent. Accordingly, Entity D estimates that expected credit losses on the loan to Entity F is $4,000.

Conforming amendments and clarifications

ASUs 2019-04 and 2019-11 make a variety of conforming amendments to the guidance in ASC 326, which mostly amend cross-references and align guidance in other subtopics with the amendments introduced in ASU 2016-13. These amendments are not intended to make substantive changes to the CECL model.

ASU 2019-04 does clarify that reinsurance recoverables resulting from insurance transactions within the scope of ASC 944, *Financial Services – Insurance*, are within the scope of the CECL model, even if those reinsurance recoverables are measured on a net present value basis in accordance with ASC 944.

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relevant facts and circumstances, including the pertinent authoritative literature, need to be considered to arrive at conclusions that comply with matters addressed in this bulletin.

For additional information on topics covered in this bulletin, contact your Grant Thornton LLP professional.

D. Appendix – Vintage disclosure table

	Term Loans Amortized Cost Basis by Origination Year								
As of December 31, 20X5	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	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3–4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total residential mortgage loans	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Residential mortgage loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-	-	-	-
Current-period net writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Consumer:									
Risk rating:									
1–2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3–4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total consumer	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Consumer loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-	-	-	-
Current-period net writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Commercial business:									
Risk rating:									
1–2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3–4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total commercial business	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Commercial business loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-	-	-	-
Current-period net writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Commercial mortgage:									
Risk rating:									
1–2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3–4 internal grade	-	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-	-
Total commercial mortgage	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Commercial mortgage loans:									
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-	-	-	-
Current-period net writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -

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