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CPAs & BUSINESS ADVISORS

ACCOUNTING UPDATE

November 10, 2023

LEASE UPDATES AND LESSONS LEARNED


ONGOING LEASE CONSIDERATIONS
Not a one-time or annual event – for financial reporting or tax

LEASE CLASSIFICATION

Financing lease if it meets any of the following:

1. Ownership transfer by the end of the lease term.

2. Option to purchase the underlying asset that lessee is reasonably certain to exercise.

3. Lease term is a major part of the remaining economic life of the underlying asset.

4. Present value of the lease payments equals or exceeds substantially all of the fair value of the underlying asset.

5. NEW: Underlying asset is specialized in nature that it is expected to have no alternative use at the end of the lease term.

LEASE MODIFICATIONS AND REMEASUREMENTS

MODIFICATION IS ACCOUNTED FOR AS SEPARATE CONTRACT IF BOTH CONDITIONS MET

- Additional right of use not included in original lease.
- Priced at standalone price of the additional right of use.

LEASE REMEASUREMENTS

- Contract modification determined not be separate contract.
- Changes in probable amounts due under residual value guarantee.
- Variable lease payments become fixed lease payments when contingency is resolved.

* Significant event or change in circumstance that is <u>within control of lessee</u> that effects reasonably certainty regarding renewal/termination/purchase options.

* <u>Event in contract happens</u> that requires lessee to exercise renewal option or terminate lease.

* <u>Elects or does not elect</u> to exercise a renewal options previously determined to be(or not be) reasonably certain.

    * Remeasure based on trigging event.

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REMEASUREMENT CONSIDERATIONS

Examples of significant events or significant changes in circumstances

- Construction of significant leasehold improvements.
- Significant modification or customization of underlying asset.
- Business decision that is directly relevant to lessee's ability exercise/not exercise options.
- Subleasing the underlying asset for period beyond exercise date of option.

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REMEASUREMENTS

	Contract modification	Reassessments from Events		
		Renewal, Termination, Purchase Options	Change in Residual Value Guarantee	Variable Payment Contingency Resolution
Remeasure liability/ROU	✓	✓	✓	✓
Reassess Classification	✓	✓	X	X
Update discount rate	✓	✓	X	X

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REMEASUREMENTS

Additional remeasurement considerations:

- If modification reduces scope (reduces number of assets leased, i.e. trucks):
  - Adjust ROU in a proportionate manner.
  - Net difference in lease liability and ROU recorded in earnings.

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LEASE REMEASUREMENT EXAMPLE

Lease for 10,000 square feet of office space for 10 years with 5-year renewal option, not reasonably certain to exercise renewal option at commencement.

End of year 7 – lessee installs significant leasehold improvements that useful life extends beyond original 10-year lease, now reasonably certain to exercise renewal option.

Reassess lease classification based on updated lease payments at end of year 7 with lease payments for 8 years (remaining 3 years and 5-year renewal) and discount rate.

Remeasure lease liability at end of year 7 and difference between remeasured lease liability and carrying amount of existing lease liability recorded to right of use asset.

LEASE NOT TO BE REMEASURED

Lease for 10,000 square feet of office space for 10 years with 5-year renewal option, not reasonably certain to exercise renewal option at commencement.

End of year 7 – city invests in major road infrastructure increasing access to the location, now reasonably certain to exercise renewal option.

As the event is not in the control of the lessee, it would not be a triggering event for reassessing the lease term.

ASC 842 – COMMON CONTROL LEASES

RELATED PARTY CONSIDERATIONS

Related party leases:

- Recognition and measurement requirements on the basis of legally enforceable terms and conditions of the arrangement.
- Should be the same classification and accounting as unrelated parties.
- Apply related party transactions disclosure requirements.
- Operating entity / leasing entity arrangements.

LEGALLY ENFORCEABLE TERMS AND CONDITIONS

ASC 842-10-55-23

"An entity should determine the noncancellable period of a lease when determining the lease term. When assessing the length of the noncancellable period of a lease, an entity should apply the definition of a contract and determine the period for which the contract is enforceable. **A lease is no longer enforceable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.**"

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ASU 2023-01 – COMMON CONTROL LEASES – ISSUE 1

Issue 1: What terms and conditions an entity should consider for:

a. Determining whether a lease exists and, if so,

b. The classification and accounting for that lease

Change: Allow non-public business entities a practical expedient to use written terms and conditions for determining whether a lease exists and the related classification and accounting without separately evaluating the legal enforceability of the written terms.

ASU 2023-01 – COMMON CONTROL LEASES – ISSUE 1 (CONT'D)

Issue 1: What terms and conditions an entity should consider for:

a. Determining whether a lease exists and, if so,

b. The classification and accounting for that lease

- Allowed to be applied on an arrangement-by-arrangement basis.
- Only allowed for arrangements in writing, disallowed if there are no written terms and conditions.

ASU 2023-01 – COMMON CONTROL LEASES – ISSUE 2

Issue 2: Accounting for leasehold improvements with leases between entities under common control.

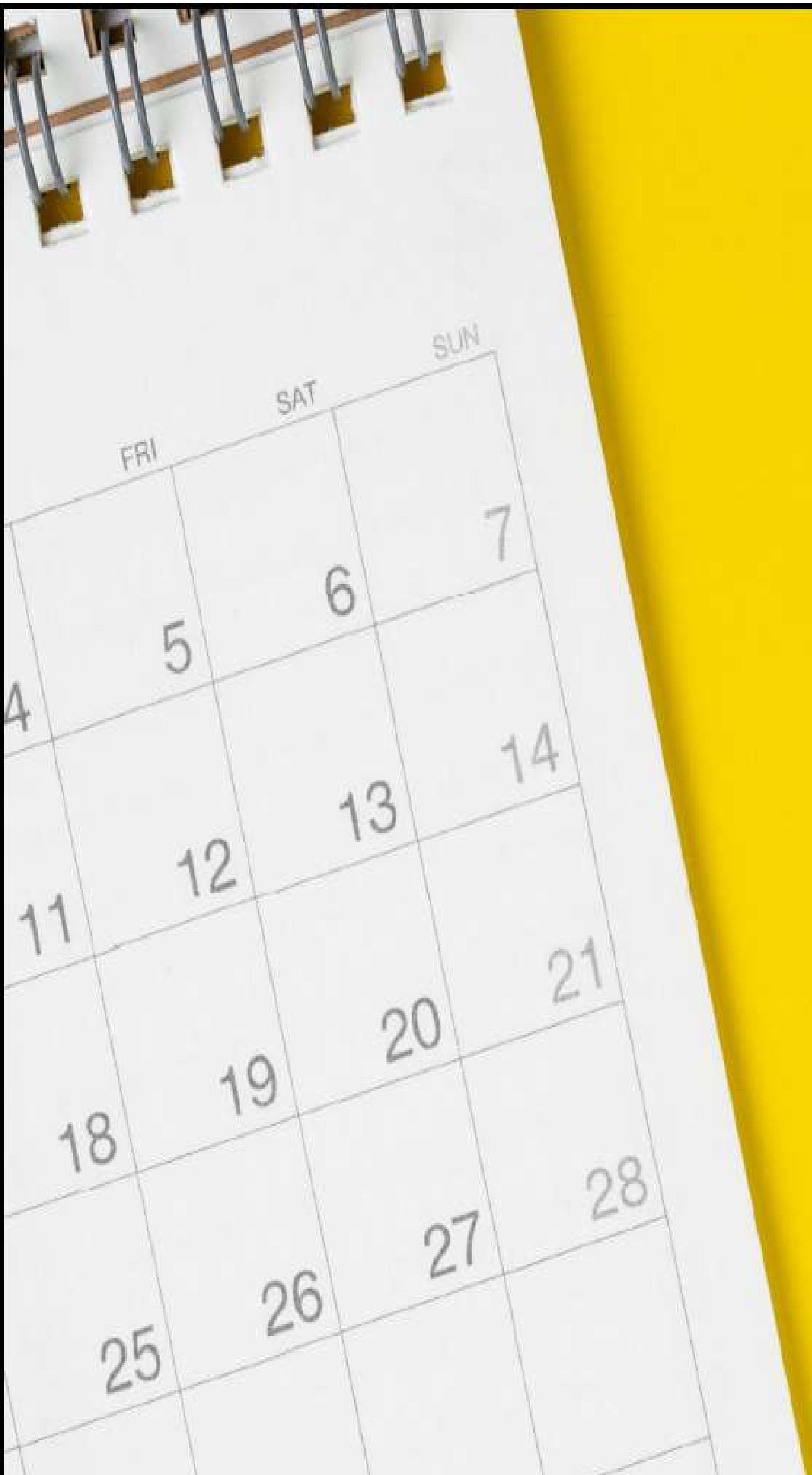
Change:

1. Leasehold improvements to be amortized over their useful life as long as the lessee continues to use the underlying asset, except for when the lessor obtained the underlying asset through a lease with an unrelated third party.
2. If lease is terminated before end of amortization period, account for remaining leasehold improvements as a transfer to the common control lessor.

ASU 2023-01 – COMMON CONTROL LEASES – ISSUE 2 (CONT'D)

Issue 2: Accounting for leasehold improvements with leases between entities under common control.

Note: Leasehold improvement still subject to impairment considerations in accordance with ASC 360: *Property, Plant, and Equipment*.



ASU 2023-01 – EFFECTIVE DATE

Effective: Fiscal years beginning after December 15, 2023 (i.e. 12/31/24 year ends):

- Early adoption is allowed.
- May be adopted in conjunction with adoption of ASC 842.

ASU 2023-01 – TRANSITION AT ADOPTION

Transition methods allowed:

- Prospectively to arrangements that commence or are modified after the implementation date.
- Retrospectively to the beginning of the first period in which ASC 842 was adopted.

Note: Regardless of transition approach, an entity is permitted to document any existing terms and conditions of a common control arrangement before the first interim or annual issuance date.

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CURRENT EXPECTED CREDIT LOSSES (CECL)

ASU 2016-13 (ASC TOPIC 326)

RECAP FOR NON-FINANCIAL INSTITUTIONS

- Scope: Applies to ALL FASB entities.
- Nonpublic entities: effective fiscal years beginning after December 15, 2022:
  - Transition - Cumulative effect adjustment at the beginning of the first reporting period in which the standard is effective.
- Changes in Terminology, Reporting and Disclosure.

STEP 1 – IDENTIFY POTENTIALLY IMPACTED ASSETS

What is in scope of the CECL model of ASC 326?

- Financial assets measured at amortized cost basis:
  - Financing receivables
  - Held-to-maturity debt securities
  - Trade A/R
  - Reinsurance receivables
  - Receivables relating to repurchase agreements and securities lending agreements
  - Net investments in leases (lessor)
  - Off-balance sheet credit exposures not accounted for as insurance

Credit loss model not applicable to the following:

- Financial assets measured at FV through net income (e.g. equity securities)
- AVS debt securities (separate considerations under ASC 326-30)
- Loans made to participants by defined contribution EE benefit plans
- Policy loan receivables of an insurance entity
- Promises to give (pledges receivable) of a NFP entity
- Loans and receivables between entities under common control
- Receivables arising from operating leases under ASC 842

STEP 2 – SELECT METHODOLOGY

- Various Methods May be Used, including but not limited to:
  - Methods using an aging schedule.
  - Discounted cash flows methods.
  - Loss-rate, roll-rate, probability of default methods, etc.

ASSETS MEASURED AT AMORTIZED COST

- Initial measurement:
  - At the reporting date, a company should record an allowance for credit losses on financial assets and report in net income, as a credit loss expense, the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on financial assets.
  - If a group of financial assets share similar risk characteristics, then companies should estimate expected credit losses on a collective, or "pool" basis.
  - The allowance for credit losses can be estimated using numerous methods.

EXAMPLES: ESTIMATION METHODS

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

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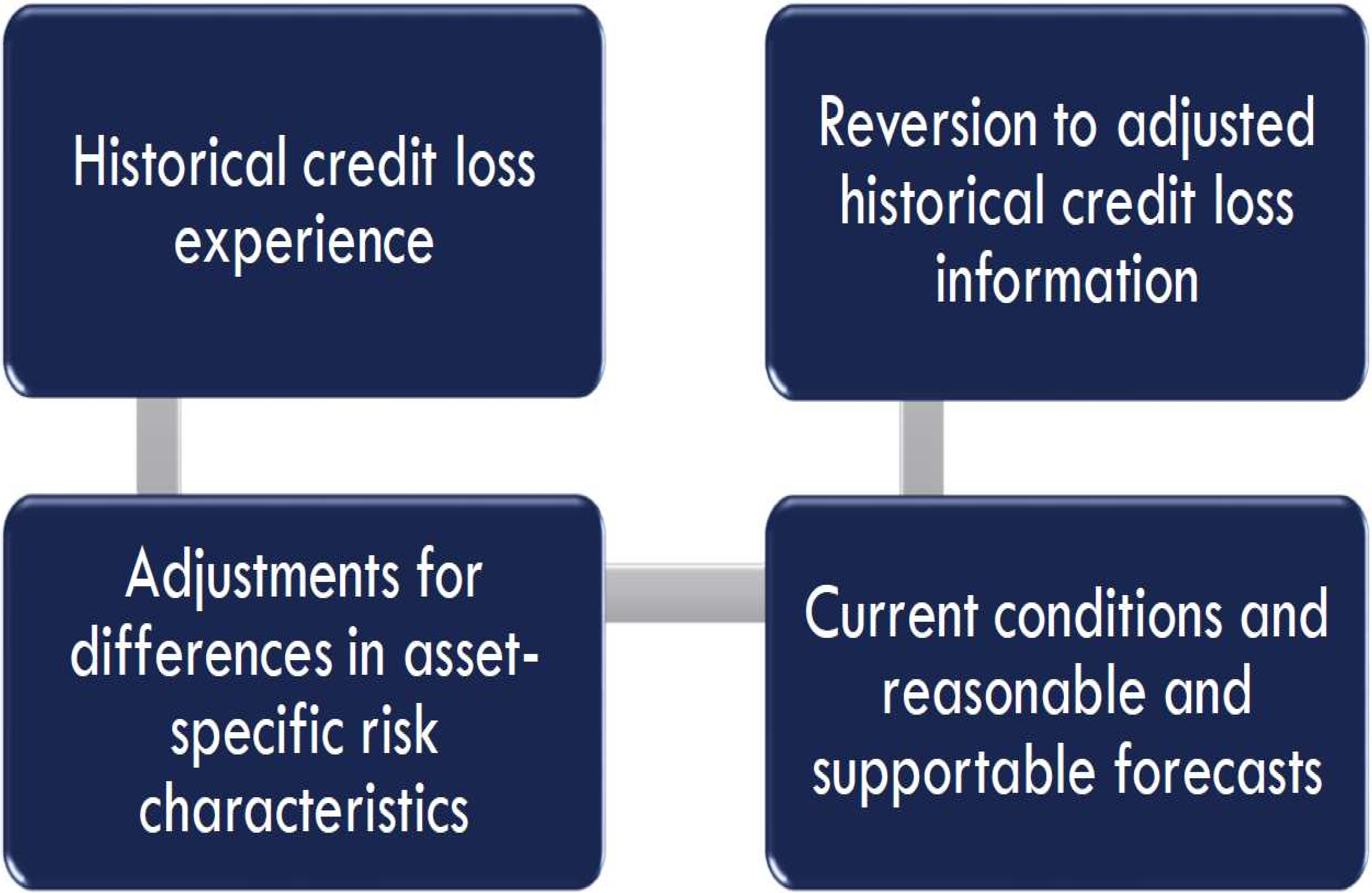
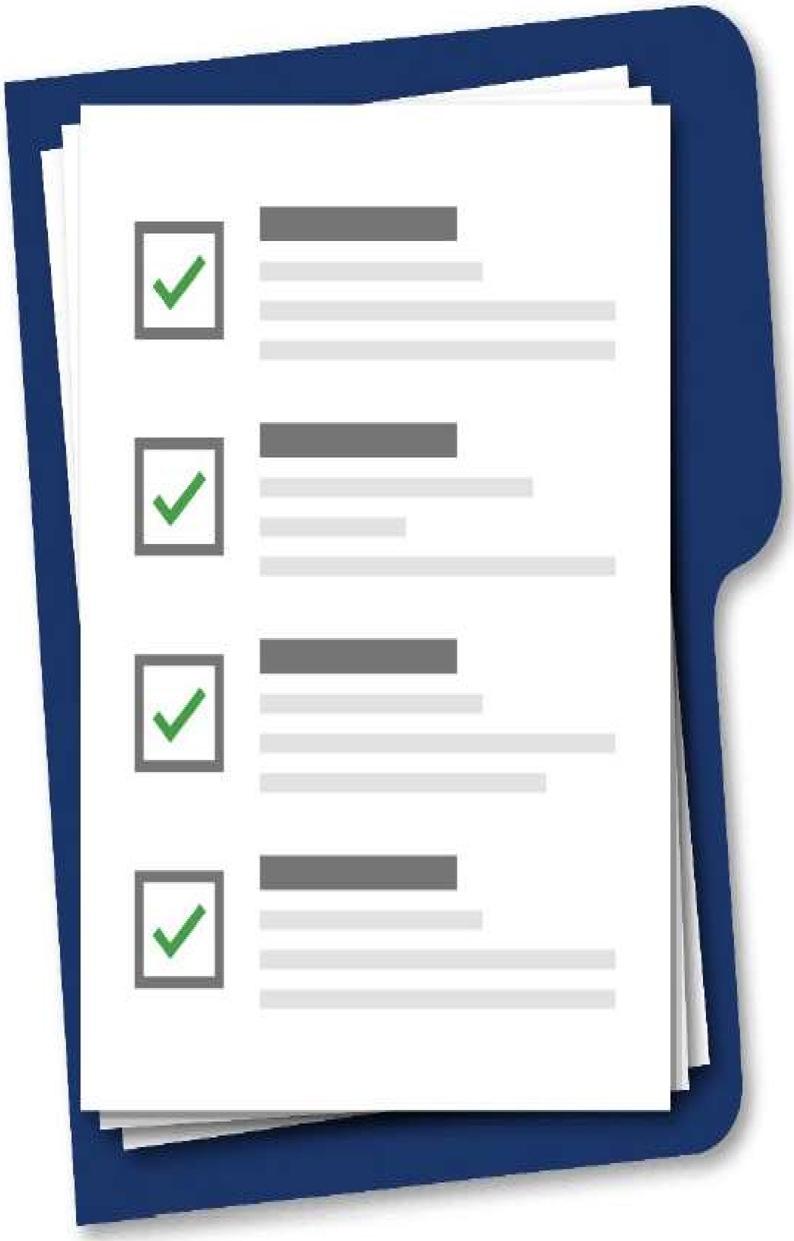
ESTIMATES REPRESENT LIFETIME LOSSES



STEP 3 – GATHER DATA AND ESTIMATE EXPECTED CREDIT LOSSES



- Historical loss experience.
- Current conditions.
- Forecasts over collection period.

STEP 3 – GATHER DATA AND ESTIMATE EXPECTED CREDIT LOSSES

Available information shall be considered relevant to assessing the collectability of cash.

"Unless we receive the outstanding balance within ten days, we will have no choice but to destroy your credit rating, ruin your reputation, and make you wish you were never born. If you have already sent the seven cents, please disregard this notice."

STEP 3 – GATHER DATA AND ESTIMATE EXPECTED CREDIT LOSSES

Available information shall be considered relevant to assessing the collectability of cash flows, including:

- Past events, current conditions, and reasonable and supportable forecasts.
- Internal and external information relating to the above, as applicable.
- Qualitative and quantitative factors that relate to the environment in which the entity operates and are specific to the borrower(s).

Source: https://backtothefuture.fandom.com/wiki/Locomotive_131?file=Delorean-locomotive_2.jpg

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FACTORS TO CONSIDER WHEN ADJUSTING HISTORICAL EXPERIENCE

- Borrowers financial condition, credit rating or credit score
- Borrowers' ability to make principal or interest payments
- Terms of remaining payments
- Remaining time to maturity
- The value/nature of the underlying collateral
- Experience and abilities of management, lending employees and other staff
- The quality of the entity's credit review system
- Borrower's environmental factors:
  - Regulatory, legal or technological environment
  - Expected change in geographical area or industry
  - International, national, regional or local economic business conditions

REASONABLE AND SUPPORTABLE FORECASTS

- Significant judgement required.
- Forecast only through the period for which the forecast is reasonable and supportable.
- Reversion to historical rate is on a straight-line basis or another rational systematic basis.
- Period of forecast is typically short.
- Maintain documentation of the source/ relevant data used.

Types of relevant data:

- Unemployment rates
- Property values
- Commodity values
- Delinquency rates
- Inflation
- Interest rates
- Other as applicable

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WAYS TO MEASURE EXPECTED CREDIT LOSSES

DCF method	• Expected credit losses are determined by comparing the asset's amortized cost with the present value of the estimated future principal and interest cash flows.
Loss-rate method	• Expected credit losses are determined by applying an estimated loss rate to the asset's amortized cost basis.
Roll-rate method	• Expected credit losses are determined by using historical trends in credit quality indicators (e.g., delinquency, risk ratings).
Probability-of-default method	• Expected credit losses are determined by multiplying the probability of default (i.e., the probability the asset will default within the given time frame) by the loss given default (the percentage of the asset not expected to be collected because of default).
Aging schedule	• Expected credit losses are determined on the basis of how long a receivable has been outstanding (e.g., under 30 days, 31–60 days). This method is commonly used to estimate the allowance on trade receivables.

EXAMPLE – ALLOWANCE MEASUREMENT

- ABC Co. has $30 million in trade receivables. Under prior GAAP, the allowance of $3 million is based on aging at period end using historical loss rates as follows:
  - 0% current receivables - $17 million, 5% 1-30 days past due - $7 million, 25% 31-60 days past due - $3 million, 50% 61-90 days past due - $2 million, 90% > 90 days past due - $1 million.
  - Expected increase in unemployment over the next 18 months, estimate impact using past experience.

Aging (Past Due)	Amortized Cost Basis	Existing Loss Rate	Existing Allowance	New Adjusted Loss Rate	Allowance under CECL
Current	$17,000,000	0%	$0	1.5%	$255,000
1-30 days	$7,000,000	5%	$350,000	6%	$420,000
31-60 days	$3,000,000	25%	$750,000	26%	$780,000
61-90 days	$2,000,000	50%	$1,000,000	51%	$1,020,000
> 90 days	$1,000,000	90%	$900,000	95%	$950,000
Allowance			$3,000,000		$3,425,000

ALTERNATIVE EXAMPLE – ALLOWANCE MEASUREMENT

- XYZ Co. sells widgets on net 30-day terms.
- Customer mix is consistent, so credit risk characteristics is consistent.
- Best economic indicator that correlates to past bad debt expense is unemployment rate, which has improved. As a result, economic conditions are more favorable than previously and expected to continue to drop (economic conditions will continue to improve).

	Current	1-30 days past due	31-60 days past due	61-90 days past due	> 90 days past due
Actual historical loss rate	0.10%	2.00%	3.50%	5.00%	8.00%

Actual historical loss rates on accounts receivable.

	Current	1-30 days past due	31-60 days past due	61-90 days past due	> 90 days past due
Actual historical loss rate	0.10%	2.00%	3.50%	5.00%	8.00%
Adjustment	10%	10%	10%	10%	10%
Current expected loss rate	0.09%	1.80%	3.15%	4.50%	7.20%

10% adjustment to historical loss rates.

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ALTERNATIVE EXAMPLE (CONTINUED)

Calculating current expected credit losses:

	Current	1-30 days past due	31-60 days past due	61-90 days past due	> 90 days past due	
Actual historical loss rate	0.10%	2.00%	3.50%	5.00%	8.00%	
Adjustment	10%	10%	10%	10%	10%	
Current expected loss rate	0.09%	1.80%	3.15%	4.50%	7.20%	
Accounts receivable	$400,000	$200,000	$180,000	$150,000	$70,000	Total = $1,000,000
CECL Allowance	$360	$3,600	$5,670	$6,750	$5,040	Total = $21,420

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EXAMPLE – VINTAGE-YEAR BASIS

- Higher Education Institution C offers loans to students. The institution originates consistent loans each year. Management estimates credit losses using a vintage year approach. Based on experience management develops the table below (next slide) for the year ended December 31, 20X9. In addition, management considers the following key observations:
  - Unemployment rates started rising in 20X4 and the loss experience for loans originated in 20X6 has already equaled the loss experience for 20X5 despite the fact the 20X6 loans will be outstanding for one additional year.
  - In considering reasonable and supportable forecasts, the institution has noted that economic analysts expect unemployment to continue to rise in 20Y0 at a national level.
  - In addition, a significant employer in the geographic region of Institution C recently determined they will be moving their headquarters out of the region.

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EXAMPLE – VINTAGE-YEAR BASIS (CONTINUED)

Year of Origination	Loss Experience in Years Following Origination					
	Year 1	Year 2	Year 3	Year 4	Total	Expected
20X1	$50	$120	$140	$30	$340	-
20X2	$40	$120	$140	$40	$340	-
20X3	$40	$110	$150	$30	$330	-
20X4	$60	$110	$150	$40	$360	-
20X5	$50	$130	$170	$50	$400	-
20X6	$70	$150	$180	$60	$460	$60
20X7	$80	$140	$190	$70	$480	$260
20X8	$70	$150	$200	$80	$500	$430
20X9	$70	$160	$200	$80	$510	$510

Total Allowance for Credit Loss at December 31, 20X9 - $1,260

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POTENTIAL FOR DEFAULT – EXPECTED NON-PAYMENT IS ZERO

- Entity J invests in U.S. Treasury securities with the intent to hold them to collect the contractual cash flows to maturity. As a result, Entity J classifies its U.S. Treasury securities as held to maturity and measures the securities on an amortized cost basis.
- Entity J believes there is a possibility of default, but considers it remote.
- Management considers:
  - Long history of no credit losses for U.S. Treasury securities.
  - U.S Treasuries are fully guaranteed by a sovereign entity that can print its own currency.
  - Currency is viewed as reserve currency and routinely held by central banks and financial institutions.
  - Historical credit loss information should be minimally affected by current conditions and reasonable and supportable forecast.
- Entity J does not record expected credit losses on U.S. Treasury Securities.

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PURCHASED FINANCIAL ASSETS WITH CREDIT DETERIORATION

- Bank O records the acquisition of PCD assets based on the amortized cost, which is the sum of the purchase price adjusted for the allowance for estimated credit loss. Any difference between the amortized cost and the par value is recorded as a discount or premium. The credit related discount is not accreted into income after the acquisition date. Bank O purchases an asset for \$750,000 with par value of \$1 million. The estimated credit loss is \$175,000. The journal entry would be as follows:

Loan – par amount	\$1,000,000	
Loan – non-credit discount		\$75,000 (for example low interest rate)
Allowance for credit losses		\$175,000
Cash		\$750,000

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IDENTIFYING SIMILAR RISK CHARACTERISTICS IN REINSURANCE RECEIVABLES

- Reinsurance receivables may comprise of variety of risks that affect collectability including:
  - Credit risk of the reinsurer/assuming company.
  - Disputes related to contractual coverage.
  - Other issues including reinsurance billing or allocation matters.
- For reinsurance receivables with varying risk characteristics, management should assess expected credit losses individually. A lack of similar credit risk characteristics could be due to:
  - Customized or customizable reinsurance agreements.
  - Differences in the financial position of reinsurers.
  - Differences in attachment points between reinsurance agreements.
  - Differing collateral terms (such as collateral trusts or letters of credit).
  - Existence of state-sponsored reinsurance programs.

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ASSETS MEASURED AT AMORTIZED COST

- Subsequent measurement:
  - At each reporting date, companies must record an allowance for credit losses on all financial assets and compare their current estimate with the prior one.
  - The adjustment necessary to achieve the appropriate allowance for credit losses should flow through net income for each reporting period. Companies must report the amount needed to adjust the credit allowance to reflect management's current estimate of the expected credit loss. This should be reported as either a credit loss expense or a reversal of a credit loss expense.

EXAMPLE: FINANCIAL ASSETS IN A POOL

While the provisions allow assessments of financial asset groups, management should periodically evaluate such groups to determine whether individual items should be shifted into different groups or evaluated individually based on changes in circumstances or risk characteristics.

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ASSETS MEASURED AT AMORTIZED COST

Write-offs and recoveries

Write-offs of financial assets can be either partial or full write-offs and must be deducted from the credit allowance in the period management determines the asset is uncollectible. The standards also state that any recoveries of assets previously written off should be recorded once collection is received.

Stakeholders questioned the guidance because it seemed to disallow the inclusion of credit recoveries when estimating credit losses. Additionally, companies questioned how to account for scenarios in which management expects to collect more than the amortized cost basis of the security.

In response, the FASB clarified in ASU 2019-04 that companies could factor recoveries in estimating credit loss allowances, but the anticipated recovery amount should not be greater than the total amount previously written off.

Also, for financial assets dependent on collateral, the standards state that any allowance added to the value of the asset should not be greater than the amount previously written off.

EXAMPLE – RECOGNIZING WRITE-OFFS AND RECOVERIES

- Bank K evaluates its loan to Entity L on an individual basis as no longer exhibits similar risk characteristics with other loans in the portfolio.
- At end of period, amortized cost basis is $500,000, allowance $375,000
- Following first quarter, Entity L files for bankruptcy and Bank K determines $500,000 loan is uncollectible and will measure full credit loss and write off loan balance.

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

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EXAMPLE – RECOGNIZING WRITE-OFFS AND RECOVERIES

- Following year, Bank K receives a partial payment of $50,000 from Entity L for loan previously written off.
- Upon receipt of the payment, Bank K recognizes the recovery:

Dr. Cash	$50,000	
Cr. Allowance for credit losses (recovery)		*$50,000

- Bank K estimates there is no change to its allowance for credit losses other than the recovery and will need to adjust the allowance to reflect the current estimate:

Dr. Allowance for credit losses	$50,000	
Cr. Credit loss expense*		$50,000

* Alternatively, Bank K could record recovery of $50,000 directly as a reduction to credit loss expense.

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STEP 4 – DETERMINE FINANCIAL STATEMENT DISCLOSURES

- Disclosures should enable a FS user to understand the following:
  - Management's method for developing the allowance.
  - Circumstances that caused changes to the allowance.
- A roll forward of the allowance for credit losses is also a required disclosure.

ASSETS MEASURED AT AMORTIZED COST

Disclosures:

- The standards provide disclosure guidance for the following:
  - Credit quality information.
  - Allowance for credit losses:
    - Rollforward of the allowance for credit losses.
  - Past-due status.
  - Non-accrual status.
  - Purchased financial assets with credit deterioration.
  - Collateral-dependent financial assets.
  - Off-balance-sheet credit exposures.

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ASSETS MEASURED AT AMORTIZED COST

Other presentation matters

- On the balance sheet, companies should present the allowance for credit losses separately, as a deduction from an asset's reported amortized cost.
- Companies should present a liability in the amount of an estimate of the expected credit loss for off-balance-sheet items on the balance sheet. This liability must be reduced or removed when the off-balance-sheet credit risk expires, results in the recording of a financial asset, or is settled.

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FINANCIAL STATEMENT PRESENTATION

Asset Type	Balance Sheet - Asset Balance	Balance Sheet - Allowance for Expected Credit Losses	Income Statement
Financial assets measured at amortized cost, including: • Loans • HTM debt securities • Trade and lease receivables	Presented at amortized cost.	Presented separately from the asset's amortized cost balance.	Expected credit losses presented as a credit loss expense.
Loan commitments and other off-balance sheet instruments.	N/A, since these are unrecognized financial instruments.	Presented as a liability. Liabilities cannot be included with other allowances for expected credit losses.	Expected credit losses presented as a credit loss expense.

PRESENTATION EXAMPLE

	20CY		20PY	
Assets				
Current Assets				
Cash and cash equivalents	$	-	$	-
Restricted cash		-		-
Receivables		-		-
Trade, net of allowance for credit losses of [$0,000] in 20CY and [$0,000] in 20PY		-		-
Related party		-		-
Income taxes				
Notes, net of allowance for credit losses of [$0,000] in 20CY and [$0,000] in 20PY		-		-
Other		-		-

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AVAILABLE-FOR-SALE DEBT SECURITIES

The term debt security refers to any security representing a creditor relationship with an entity.

A debt security also includes:

- Certain types of preferred stock
- Certain types of collateralized mortgage obligations
- U.S. Treasury securities
- U.S. government agency securities
- Municipal securities
- Corporate bonds
- Convertible debt
- Commercial paper
- All securitized debt instruments
- Interest-only and principal-only strips

A debt security excludes:

- Option contracts
- Financial futures contracts
- Lease contracts
- Receivables that do not meet the definition of a security, such as:
  - Trade receivables related to credit sales by commercial or industrial companies
  - Loan receivables related to commercial, consumer, and real estate lending by financial companies

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AVAILABLE-FOR-SALE DEBT SECURITIES

- Initial measurement:
  - Reporting financial instruments using available-for-sale accounting recognizes value could be received by either collecting contractual cash flows or selling a security.
  - Available-for-sale debt securities are considered a purchased financial asset with credit deterioration when a credit loss is expected.
  - Allowances for credit losses must be measured at the individual level for purchased financial assets with credit deterioration, not collectively.
  - Estimated credit losses must be recorded at the present value of the security's expected cash flows when purchased.
  - Holding gains or losses must be reported through other comprehensive income after tax. Any changes in the credit loss allowance during the life of the instrument must be reported through net income as a loss or as a reversal of a loss.

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AVAILABLE-FOR-SALE DEBT SECURITIES

- Subsequent measurement:
  - Companies must determine whether the fair value of individual debt securities is less than the reported amortized cost of the asset as a result of either credit loss or other factors.
  - Impairment of these assets should be reported using the allowance for credit losses, but the allowance can't be greater than the difference between fair value and amortized cost. If an impairment occurs that was not recorded using an allowance, then it must be reported in other comprehensive income after tax.
  - Impairments must be determined at the individual security level, which is the same method used to determine unrealized or realized losses or gains on debt securities.

EXAMPLE: ASSESSING AT THE INDIVIDUAL SECURITY LEVEL

If an issuer purchases debt securities with the same Committee on Uniform Security Identification Procedures (CUSIP) number separately, it can aggregate the value of those securities for reporting purposes using an average cost basis to record unrealized or realized losses and gains. However, it is not acceptable to use this combined lot to report a "general allowance" that is an unidentified impairment on a portfolio of securities.

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EXAMPLE

- Fair value $250,000, Amortized cost basis $305,000
- Purchase date 3/31/2021, Maturity date 12/31/2022 – reporting 12/31/21
- Future expected cash flows through maturity date using DCF method $265,000

Dr. AFS credit loss expense	$40,000	
Cr. Allowance for AFS credit loss		$40,000

(to record impairment related to credit: $305,000 - $265,000)

Dr. Unrealized loss on AFS debt security (equity adjustment)	$15,000	
Cr. AFS security		$15,000

(to record impairment not related to credit: $265,000 - $250,000)

- Alternatively, facts remain same, except the fair value at 12/31/21 is $275,000

Dr. AFS credit loss expense	$30,000	
Cr. Allowance for AFS credit loss		$30,000

(to record impairment not related to credit: $305,000 - $275,000)

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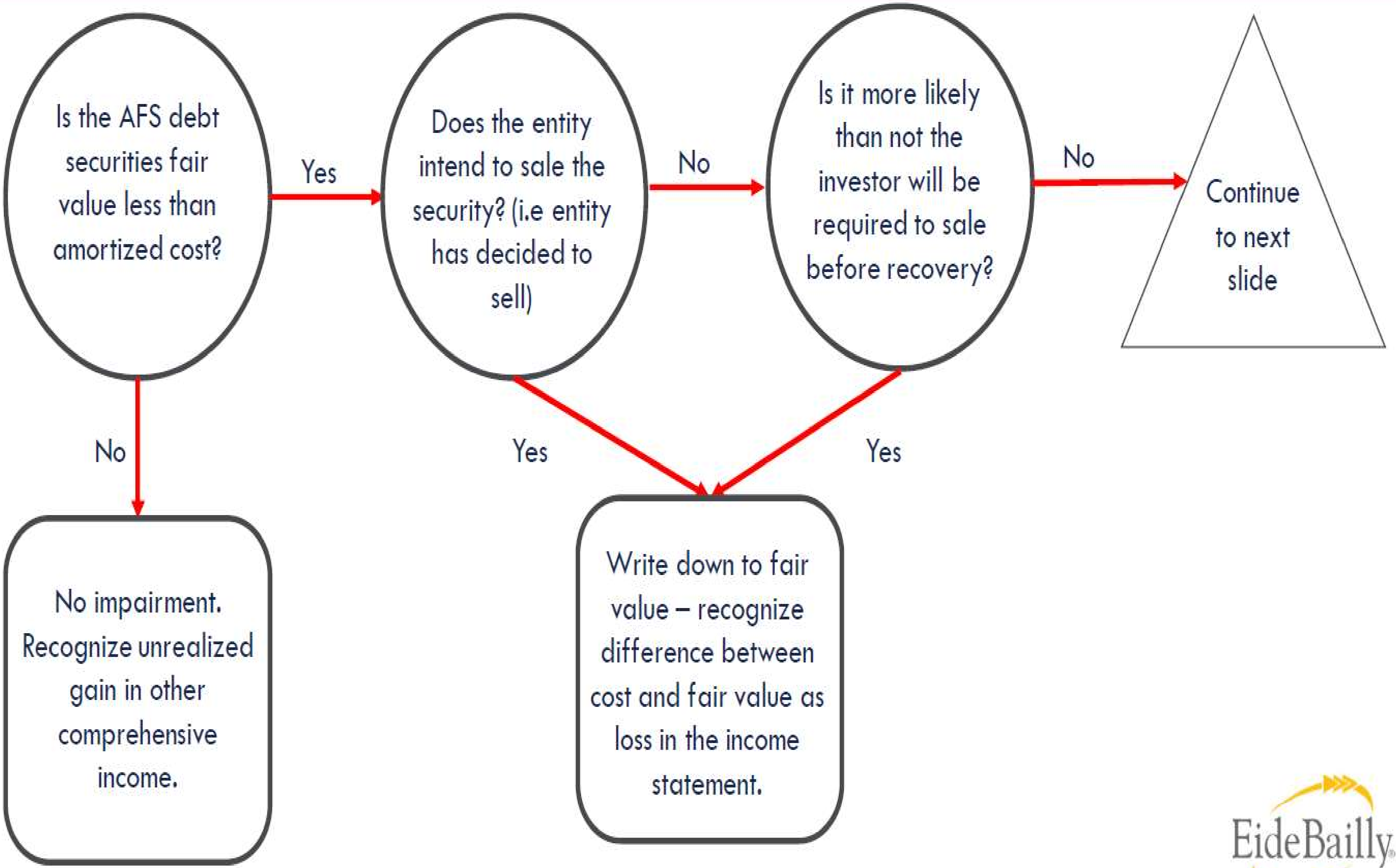
AVAILABLE FOR SALE DEBT SECURITY FLOW



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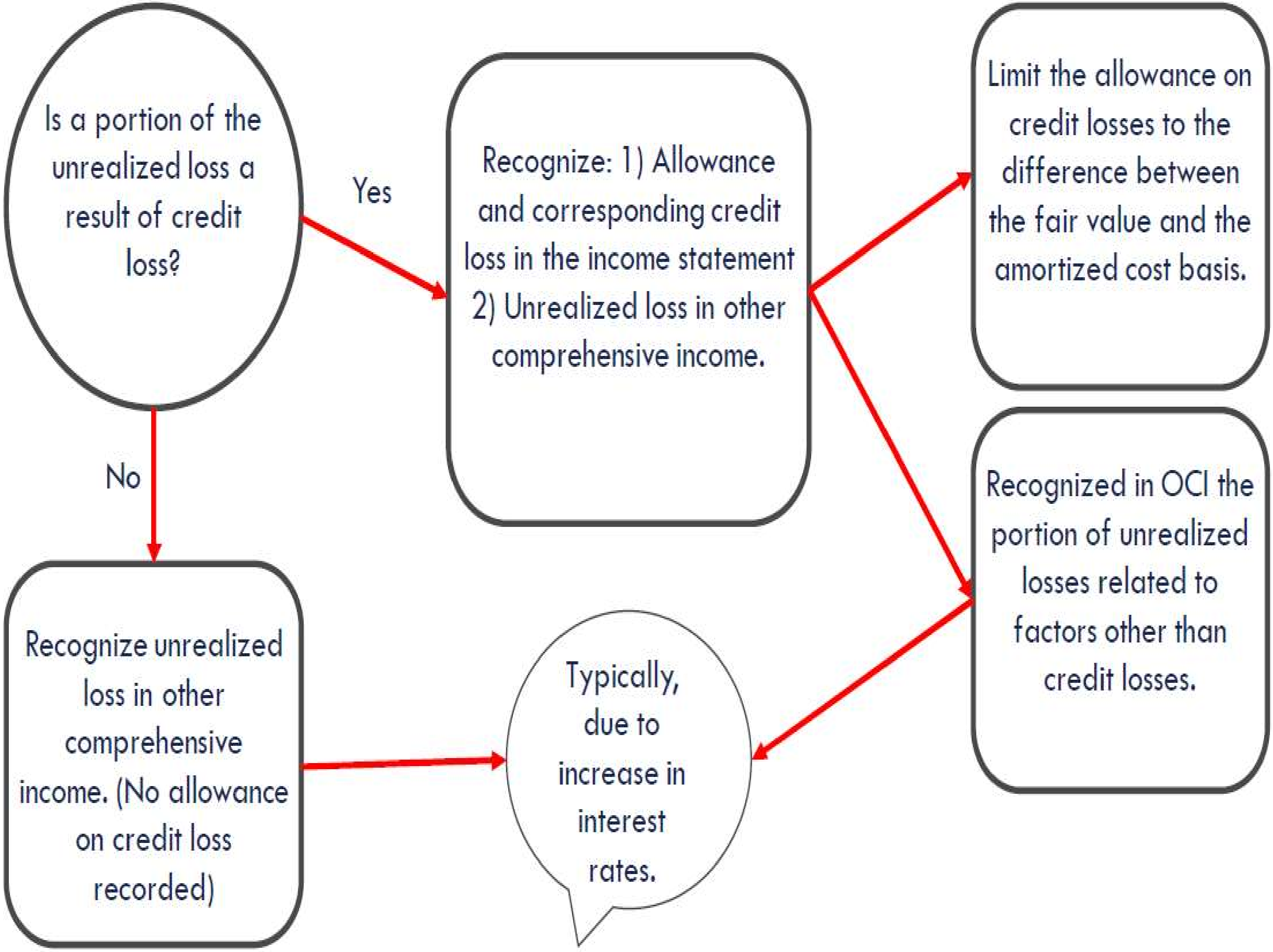
AFS DEBT SECURITY FLOW – CONTINUED



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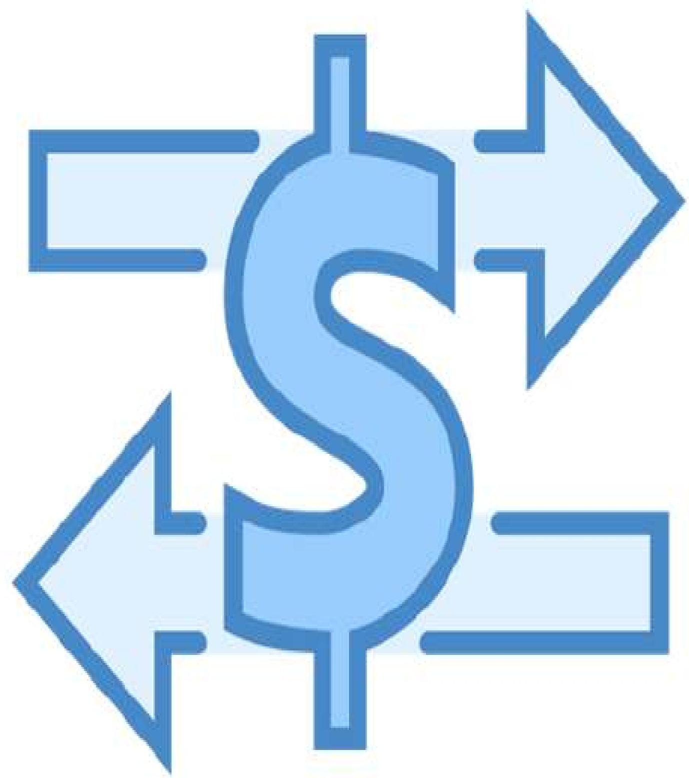
AVAILABLE-FOR-SALE DEBT SECURITIES

- Transfers between classifications or categories for loans and debt securities:
  - Guidance in ASU 2016-13 addressed the topic of transfers, but there was a question as to how to account for transfers of mortgage and non-mortgage loans between not held-for-sale and held-for sale categories.
  - Another issue came up regarding Subtopic 320-10, which provides guidance on debt securities in general. Companies questioned the way in which they should account for the allowance when transferring debt between held-to-maturity and available-for-sale classifications.
  - These issues led to the issuance of new guidance through ASU 2019-04. These amendments require that companies reverse any credit loss allowance previously recorded for loans or debt securities when transferring the security to a new category or classification. The reversal should be recognized on the income statement. Then the appropriate measurement guidance for the new classification should be applied.



AVAILABLE-FOR-SALE DEBT SECURITIES

- If an available-for-sale debt security has an unrealized loss due to an unrecognized credit loss, then companies must disclose all the following in both interim statements and annual financial statements:
  - Aggregate fair value.
  - Aggregate unrealized losses.
  - Quantitative disclosures should be supported by narrative disclosures that include all the following:
    - Nature of investment.
    - Cause of impairment.
    - Number of securities with unrealized losses.
    - Supporting evidence used for each position.

DISCLOSURES

- Allowance for credit losses:
  - Companies must disclose the methodology, security type, and significant inputs that are factored when measuring credit losses. Significant inputs include:
    - The following underlying asset performance indicators:
      - Default rates
      - Delinquency rates
      - Percentage of assets that are nonperforming
    - Debt/collateral
    - Third-party guarantees
    - Subordination
    - Vintage
    - Geographical concentration
    - Industry forecasts or analyst's reports
    - Credit ratings
    - Other data that is relevant in determining whether the security is collectible

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DISCLOSURES

- Rollforward of the allowance for credit losses:
  - For all annual and interim reporting periods, companies must disclose a tabular rollforward (by security type) of the allowance for credit losses and at a minimum include each of the following:
    - Beginning balances of credit loss allowances for debt securities.
    - Any additions to credit loss allowances that weren't recorded previously.
    - Any additions to credit loss allowances related to the purchase of available-for-sale debt securities that are accounted for as PCD assets.
    - Any reductions related to securities sold during the reporting period.
    - Any reductions in credit loss allowances related to securities that are either intended to be sold or are more likely than not to be sold before cost recovery.
    - Increases or decreases to credit loss allowances if a company doesn't plan on selling the security or it is not more likely than not the security will have to be sold prior to cost recovery.
    - Any write-offs charged against allowances.
    - Any recovery of previously written-off amounts.
    - Ending balances of the credit loss allowances on debt securities.

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DISCLOSURE EXAMPLE – AFS SECURITIES WITH CREDIT LOSSES

[Example for available-for-sale debt securities which have an allowance for credit losses established.]

Changes in the allowance for credit losses for available-for-sale debt securities are as follows for the year ended December 31, 20CY:

	U.S. Government Securities	States and Municipalities	Corporate Bonds	Total
Balance, beginning of year	$ -	$ -	$ -	$ -
Credit losses on securities without previously recorded credit losses	-	-	-	-
Net change in allowance on previously impaired securities	-	-	-	-
Securities purchased with credit deterioration	-	-	-	-
Reduction for sales of securities	-	-	-	-
Reduction due to intent to sell	-	-	-	-
Write-offs charged against the allowance	-	-	-	-
Recoveries of amounts previously written off	-	-	-	-
Increases due to the passage of time	-	-	-	-
	$ -	$ -	$ -	$ -

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AVAILABLE-FOR-SALE DEBT SECURITIES – PRESENTATION

Other presentation matters

- Companies must present available-for-sale debt securities at fair value on the balance sheet, and in parentheses the amortized cost along with any credit loss allowance.
- If a company reports any components of available-for-sale debt securities in accumulated other comprehensive income, it must separately present the allowance for credit losses.
- The application of the standards may result in changes that can be attributed to multiple factors, such as changes in present value of future cash flows, the passage of time, or changes in timing estimates and other assumptions. Companies are allowed to report the cumulative of these as a single change in present value in the income statement as an expense or reversal of a loss.

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FINANCIAL STATEMENT PRESENTATION

Asset Type	Balance Sheet - Asset Balance	Balance Sheet - Allowance for Expected Credit Losses	Income Statement
AFS debt securities	Presented at fair value. Entities must also include the security's amortized cost parenthetically. Changes in fair value unrelated to credit are presented in OCI.	Presented parenthetically.	Expected credit losses presented as a credit loss expense.

AVAILABLE-FOR-SALE DEBT SECURITIES - PRESENTATION

Investments	-	-
Available-for-Sale Debt Securities, at Fair Value (Amortized Cost of [$0,000] in 20CY and [$0,000] in 20PY; Allowance for Credit Losses of [$0,000] in 20CY and [$0,000] in 20PY)	-	-
Held-to-Maturity Debt Securities, at Amortized Cost, Net of Allowance for Credit Losses of [$0,000] in 20CY and [$0,000] in 20PY (Fair Value of [$0,000] in 20CY and [$0,000] in 20PY)	-	-
Investments in Affiliated Entities	-	-
	$ -	$ -

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TRANSITION GUIDANCE

Apply update by measuring credit loss under the new standard as of the beginning of the first reporting period in which the guidance is effective with a cumulative effect adjustment to retained earnings (modified-retrospective approach).

TRANSITION GUIDANCE – AFS & HTM DEBT SECURITIES

- What do I do if I have AFS or HTM debt securities for which I have previously (prior to date of adoption of ASC 326) written down the balance due to other than temporary impairment losses (OTTI)?

1 - At transition, the amortized cost basis of the debt security remains unchanged – including any previous write downs.

2 – For HTM debt securities, any amounts in accumulated other comprehensive income related to OTTI at the adoption date related to improvements in cash flows will continue to be accreted to interest income over the remaining life of the debt security.

3 – Recoveries of amounts previously written off that occur after the date of adoption are recorded in the period received instead of the period in which the entity's credit loss estimate has changed.

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CREDIT LOSSES

- ASU 2018-19, Codification Improvements, Financial Instruments - Credit Losses:
  - The following are key elements of ASU 2018-19:
    - Operating lease receivable impairment is included in Topic 842.
    - Other minor clarifications and improvements.
  - Effective date is same as ASU 2016-13.

CREDIT LOSSES

- ASU 2019-04, Codification Improvements, Financial Instruments - Credit Losses:
  - The following are key elements of ASU 2019-04:
    - Permits an entity to measure the allowance for credit loss on accrued interest receivable to be separated from other components of amortized cost assets.
    - It is an accounting policy election to write off accrued interest amounts by either reversing interest income or recognizing credit loss experience.
    - Include recoveries of previously written off assets in estimating the current period allowance for credit loss.
    - Other minor enhancements and clarifications.
  - Effective date depends on whether ASU 2016-13 has been adopted yet or not.

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CREDIT LOSSES

- ASU 2019-05, Financial Instruments - Credit Losses: Targeted Transition Relief:
  - The following are key elements of ASU 2019-05:
    - Provides entities that have certain instruments within the scope of FASB ASC 326-20, *Financial Instruments – Credit Losses – Measured at Amortized Cost*, with an option to irrevocably elect the fair value option in FASB ASC 825-10, *Financial Instruments – Overall*.
    - Applied on an instrument-by-instrument basis for eligible instruments.
    - Does not apply to HTM debt securities.
  - Effective date depends on whether ASU 2016-13 has been adopted yet or not.

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CREDIT LOSSES

- ASU 2019-11, Codification Improvements, Financial Instruments – Credit Losses:
  - The following are issues raised during implementation of ASU 2016-13 addressed through ASU 2019-11:
    - Issue 1 – Expected Recoveries for Purchased Financial Assets with Credit Deterioration
    - Issue 2 – Transition Relief for Troubled Debt Restructurings
    - Issue 3 – Disclosures Related to Accrued Interest Receivables
    - Issue 4 – Financial Assets Secured by Collateral Maintenance Provisions
    - Issue 5 – Conforming Amendment to FASB ASC 805-20, *Business Combinations – Identifiable Assets and Liabilities, and Any Noncontrolling Interest*
  - Effective date depends on whether ASU 2016-13 has been adopted yet or not.

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CREDIT LOSSES

- ASU 2020-02, Credit Losses (Topic 326) and Leases (Topic 842):
  - The following are key elements of ASU 2020-02 (amendments to SEC paragraphs only pursuant to SEC Staff Accounting Bulletin 119):
    - Provides a description of the measurement process for current expected credit losses.
    - Adds interpretive responses surrounding the development, governance, and documentation of a systematic methodology when applying CECL.
    - Provides guidance on the appropriate documentation of the results and validation of the systematic methodology applied.
  - Effective date depends on whether ASU 2016-13 has been adopted yet or not.

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CREDIT LOSSES

- ASU 2022-02, Financial Instruments - Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures
  - The following are key elements of ASU 2021-02:
    - Eliminates accounting guidance on troubled debt restructurings (TDRs) for creditors in ASC 310-40
    - Amends guidance on "vintage disclosures" to require disclosure of current-period gross write-offs by year of origination
    - Adds enhanced disclosures for creditors for loan refinancings and restructurings for borrowers experiencing financial difficulty
  - Effective date depends on whether ASU 2016-13 has been adopted yet or not.

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Q&A

Question - Can an entity's process for determining expected credit losses consider only historical information?

Answer – No

Question - Should an entity use external data to develop estimates of credit losses if internal information is available?

Answer - An entity can use internal information, external information, or a combination of both internal and external forms of information in developing an estimate of expected credit losses.

Question – Should an entity reevaluate its reasonable and supportable forecast period each reporting period?

Answer - Yes

Q&A

Question – I don't think my beginning trade allowance is be impacted by ASC 326 and I don't have other assets held at amortized cost, do I not need to worry about this?

Answer – No – must still consider and document how reasonable and supportable forecasts impacted (or did not impact) your evaluation of the allowance.

Question – If risk of loss is remote, do I need an allowance for credit loss?

Answer – Yes, except for limited circumstances described previously.

Q&A

Question – Are loans and receivables to equity method investees in the scope of the CECL model?

Answer – Yes

Question – Are employee forgiveable loans in the scope of the CECL model?

Answer – Possibly, to the extent the employer has a right to receive payment for the loan (including when employee is terminated). Amounts the employer expects to forgive would not be included in the estimate of credit losses.

QUESTIONS?

THANK YOU!

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