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Financial Instruments — Credit Losses

SPECIAL REPORT

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Financial Instruments — Credit Losses

Financial instruments are prevalent across all industries and entities. Examples of financial instruments are loans, receivables (including trade receivables) and securities. These instruments are subject to complex accounting rules on measuring and presenting expected credit losses. The rules help ensure that financial instruments are not overvalued in an entity's financial statements.

The accounting for credit losses under U.S. GAAP is discussed in Topic 326, Financial Instruments — Credit Losses, of the FASB Accounting Standards Codification® (ASC). Topic 326 requires an entity to record an allowance for expected credit losses on financial instruments. The allowance is adjusted each reporting period to reflect an entity's current estimate of expected credit losses.

Due to the relative newness and complexity of the standard, the accounting for credit losses is an area of focus for regulators, such as the SEC.

Public business entities that meet the definition of an SEC filer (except for those that meet the definition of a smaller reporting company, or SRC) were required to adopt Topic 326 for annual periods beginning after December 15, 2019, and for interim periods within those annual periods. All other entities must apply Topic 326 for annual periods that begin after December 15, 2022, and for interim periods within those annual periods. Early adoption is allowed. FASB ASC 326-10-65 provides detailed transition information for reporting entities still in the process of adopting the standard.

Even for reporting entities that have adopted Topic 326, many preparers continue to refine their estimation methods, processes, controls, and disclosures. Users of financial statements also continue to get accustomed to the requirements in Topic 326, such as the estimates, judgments, and disclosures involved. Due to the relative newness and complexity of the standard, the accounting for credit losses is an area of focus for regulators, such as the SEC. The accounting for credit losses also received heightened attention during the COVID-19 pandemic, which led to global uncertainty, affected borrower creditworthiness, and posed challenges for the estimation of expected credit losses.

This special report explores the accounting for credit losses under Topic 326. This includes an overview of the accounting, reminders for SEC filers, a comparison of Topic 326 to other impairment models (including the model in International Financial Reporting Standards (IFRS) 9, Financial Instruments, and prior U.S. GAAP), and tips for companies that have not yet adopted Topic 326.

Scope of the FASB's Guidance for Reporting Expected Credit Losses

Topic 326 applies to all entities.

Observation: Topic 326 does not just apply to financial institutions. Topic 326 applies to all entities with financial instruments. The effort and complexity involved in applying Topic 326 will depend on various factors, such as:

- The size of an entity's portfolio of assets.
- The composition of the portfolio.
- The level of credit risk associated with the portfolio.
- The availability of data for estimating expected credit losses.
- The company's capabilities and expertise around modeling and estimates.

Topic 326 applies to a wide range of instruments, including:

- Financial assets measured at amortized cost, such as:
  - Loans and financing receivables.
  - Held-to-maturity debt securities.
  - Trade receivables from revenue transactions with customers.
  - Receivables related to repurchase agreements or securities lending agreements.
- Net investments in leases recognized by a lessor.
- Reinsurance recoverables, whether they are measured at net present value or amortized cost.
- Loan commitments, standby letters of credit and other similar off-balance-sheet credit exposures that are not accounted for as insurance.
- Available-for-sale debt securities.

Observation: Topic 326 does not apply to equity securities. Equity securities generally are reported at fair value with changes in fair value recorded in net income under Topic 321, Investments—Equity Securities.

Financial Assets Measured at Amortized Cost

Subtopic 326-20, Financial Instruments — Credit Losses — Measured at Amortized Cost, provides guidance for financial assets measured at amortized cost, such as held-to-maturity debt securities, loans and receivables. The accounting described in Subtopic 326-20 is commonly referred to as the current expected credit loss (CECL) model.

The CECL model is based on expected losses. An entity must establish an allowance that reflects management's estimate of expected credit losses over the life of the asset.

Observation: An entity is not required to use a complex estimation method. Public entities, however, typically are held to a higher standard than nonpublic entities. In other words, public entities generally are expected to have more sophisticated and precise estimation methods than nonpublic entities because public entities tend to have access to more resources and expertise. Public entities often use discounted cash flow approaches to project their expected future cash flows and in turn, derive current expected credit losses.

Under Topic 326, an entity has the flexibility to determine which method it will use to determine the allowance. An entity might use methods that consider discounted cash flows, loss rates, roll rates, probability of default, aging analyses or other factors.

An entity must estimate expected credit losses on a collective (pool) basis for assets that have similar risk characteristics. An entity must estimate expected credit losses on an individual basis for an asset that has unique risk characteristics.

Observation: An entity must establish an allowance for an asset on either an individual basis or a collective basis. An entity must be careful not to double count an asset by both evaluating it individually and including it in a pool of assets.

To estimate expected credit losses, an entity must consider all available information that is relevant to the assessment. This includes information about past events, current conditions and reasonable and supportable forecasts. An entity must make a reasonable effort to obtain the relevant information. An entity, however, is not expected to use undue cost and effort.

An entity must estimate expected credit losses over the life of the asset (not a shorter period, such as 12 months). The life of the asset is the contractual term of the asset. An entity must consider existing contractual extension or renewal options to determine the contractual term, when these are not unconditionally cancellable by the entity. For a net investment in a lease, the contractual term is the lease term as determined under Topic 842, Leases.

An entity records an allowance for expected credit losses even if the risk of loss is remote.

Observation: In very limited cases, an entity might not expect any credit losses over the life of the asset. Thus, the entity might record an allowance equal to zero. For instance, this might be the case for a U.S. Treasury security or an instrument that is expected to be 100-percent collateralized over the life of the instrument.

Before reaching a conclusion that no credit losses are expected, an entity must consider all of the facts and circumstances. If an entity reaches this conclusion, it is important for the entity to maintain appropriate documentation to support its conclusion. The FASB expects these cases to be rare. In other words, an entity typically will foresee at least some credit losses over the life of an asset.

The allowance for expected credit losses is presented on the balance sheet as a reduction to the amortized cost basis of the assets, as shown in Figure 1.

Figure 1 — Balance Sheet Presentation for Financial Assets Measured at Amortized Cost

For off-balance-sheet credit exposures, an entity must present expected credit losses as a liability on the balance sheet. This liability must be presented separately from the allowance for credit losses. Examples of off-balance-sheet credit exposures are off-balance-sheet loan commitments, standby letters of credit and financial guarantees that are not insurance.

For off-balance-sheet credit exposures, an entity must present expected credit losses as a liability on the balance sheet.

The allowance must be remeasured each reporting period to reflect management's current estimate of expected credit losses. If an entity establishes an allowance for a pool of assets, the entity must continue to evaluate if the assets in the pool have similar risk characteristics. An entity includes expected recoveries when developing its estimate of expected credit losses. The maximum amount of expected recoveries that can be considered, however, is limited to the sum of a) any balances that were previously written off, and b) any balances that the entity expects to write off in the future.

Changes in the allowance are recorded in income. Changes in the allowance generally must be recorded as credit loss expense. An entity has a choice of how to reflect the change, however, if it uses a discounted cash flow approach to estimate expected credit losses. Figure 2 shows the two options available. This figure uses the following assumptions:

- An entity uses a discounted cash flow approach to estimate expected credit losses.
- The entity has a loan receivable. The allowance for credit losses at the beginning of the period is $5,000. The entity's estimate of expected credit losses at the end of the period is $6,000. Therefore, the total change in the allowance is $1,000. Of the total change in the allowance, $50 relates to the passage of time.

When an entity uses a discounted cash flow approach to estimate expected credit losses, the entity has two options for presenting a change in the allowance.

Figure 2 — Two Options if an Entity Uses a Discounted Cash Flow Approach

Option 1	Record the change in a single line item — credit loss expense	Dr. Credit loss expense $1,000 Cr. Allowance for credit losses $1,000
Option 2	Record the change in two line items — interest income and credit loss expense	Dr. Credit loss expense $1,050 Cr. Interest income $50 Cr. Allowance for credit losses $1,000

The effect on the balance sheet is the same under both options. The effect on the income statement, however, is different. An entity that chooses option 2 must disclose the amount of the change in the allowance recorded as interest income.

An entity must write-off all or a portion of the carrying amount of a financial asset when the entity determines that the asset is uncollectible. The write-off can be a full or partial write-off. The write-off is recorded against the allowance for credit losses. For instance, assume that an entity determines that $50,000 of a particular loan is uncollectible and records a partial write-off of the loan. Figure 3 shows the journal entry recorded for the partial write-off.

Figure 3 — Journal Entry for Write-off

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General ledger account	Debit	Credit
Allowance for credit losses	$50,000	
Loan receivable		$50,000
Total	$50,000	$50,000

Practical Expedients and Accounting Policy Elections for Financial Assets Measured at Amortized Cost

Topic 326 provides practical expedients for:

- Financial assets secured by collateral, also referred to as collateral-dependent financial assets.
- Financial assets secured by collateral maintenance provisions.

The first practical expedient pertains to financial assets secured by collateral. In the event that a borrower experiences financial difficulty, an entity may expect to be repaid substantially from the operation or sale of the collateral. If so, as a practical expedient, the entity can use the fair value of the collateral at the reporting date to determine the allowance for expected credit losses. The allowance is calculated as shown in Figure 4.

Figure 4 — Practical Expedient for Financial Assets Secured by Collateral

If repayment is expected from the ***operation*** of the collateral …	If repayment is expected from the ***sale*** of the collateral …
Amortized cost basis of asset	Amortized cost basis of asset
– Fair value of collateral	– Fair value of collateral
Allowance for expected credit losses	+ Estimated costs to sell (undiscounted)
	Allowance for expected credit losses

The second practical expedient is for financial assets secured by collateral maintenance provisions. The terms of a loan may require the borrower to adjust constantly the amount of collateral securing the loan as the fair value of the collateral changes. If so, as a practical expedient, an entity can measure the allowance for expected credit losses as the difference between the amortized cost basis of the loan and the fair value of the collateral at the reporting date. An entity that uses this practical expedient must evaluate whether it reasonably expects the borrower to be able to continually replenish the collateral.

Topic 326 also provides various accounting policy elections. For instance, it offers several optional elections related to an entity's accounting and disclosure for accrued interest. As another example, an entity can make an accounting policy election to adjust the discount rate used in accounting for credit losses for expected prepayments. Similar accounting policy elections are available for available-for-sale debt securities.

Observation: Topic 326 also provides targeted relief for recording expected credit losses for troubled debt restructurings and electing to apply the fair value option to certain financial assets previously measured at amortized cost upon transition to Topic 326.

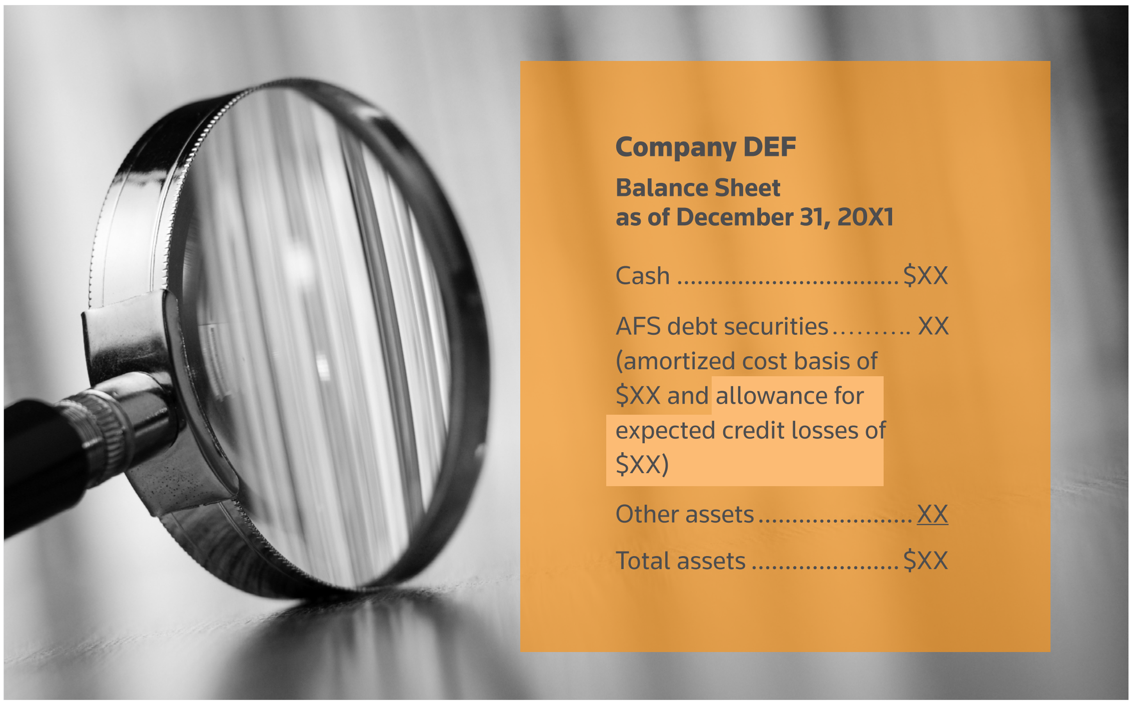
Available-for-Sale Debt Securities

The model for available-for-sale debt securities is largely based on the impairment guidance that existed under prior GAAP in Topic 320, Investments — Debt and Equity Securities. The main difference is that Subtopic 326-30 eliminated the concept of an "other-than-temporary impairment." Instead, under Subtopic 326-30, an entity must record an allowance for available-for-sale debt securities. The allowance represents management's estimate of expected credit losses over the life of the asset. The way that an entity determines expected credit losses on available-for-sale debt securities is similar to the impairment guidance that existed under prior GAAP in Topic 320, but with targeted improvements. For instance, to estimate to estimate expected credit losses under Subtopic 326-30, an entity must consider not only information about past events and current conditions (as required under prior GAAP), but also reasonable and supportable forecasts. Also, to estimate expected credit losses, an entity no longer considers certain factors that were important to evaluate impairment under prior GAAP in Topic 320, including the length of time a security is underwater, changes in a security's fair value after the balance sheet date, and historical and implied volatility.

Available-for-sale debt securities must be presented on the balance sheet at fair value. An entity must indicate the allowance for credit losses and the amortized cost basis of the securities in parentheses, as shown in Figure 5.

Observation: The difference between the amortized cost basis and the fair value of a security may not equal the allowance for expected credit losses on the security. This is because the fair value of a security is affected by not only credit risk, but also other factors. For instance, the difference between the amortized cost basis and the fair value may be comprised of both the allowance for expected credit losses and unrealized gains or losses due to changes in market interest rates.

Figure 5 — Balance Sheet Presentation for Available-for-Sale Debt Securities



The allowance for expected credit losses must be remeasured each reporting period to reflect management's current estimate of expected credit losses. Changes in the allowance are recorded in income. Changes in the allowance generally must be recorded as credit loss expense. Similar to the accounting for financial assets measured at amortized cost, an entity has a choice of how to reflect the change if it uses a discounted cash flow approach to estimate expected credit losses. See Figure 2 for the two options available in this case.

Observation: Under Subtopic 326-30, reversals of impairment are possible. This is because all changes in the allowance (both increases and decreases) are recorded in income. A decrease to the allowance essentially results in a reversal of an impairment that was recorded in a prior period. A decrease in the allowance happens when an entity's expectations about the future cash flows to be collected on a security improve. Under prior GAAP in Topic 310, reversals of impairment were not allowed for available-for-sale debt securities.

There is a limit on the amount of the allowance for available-for-sale debt securities. Specifically, the allowance is limited to the difference between the fair value and the amortized cost of the security.

> **Observation:** The FASB decided to limit the amount of the allowance for available-for-sale debt securities. This is because these securities are considered marketable. In theory, an entity can sell the securities at any point in time to recover their fair value. Therefore, the FASB determined that it is appropriate to limit the allowance to the difference between the fair value and the amortized cost of these securities.
>
> There is no similar limit on the amount of the allowance for assets subject to the CECL model. This is because assets subject to the CECL model generally are held for the purposes of collecting their cash flows (principal and interest). An entity is not expected to sell these assets in an attempt to recover their fair value.

Purchased Financial Assets with Credit Deterioration

Topic 326 defines a purchased financial asset with credit deterioration (PCD asset) as an asset that has experienced a more than insignificant decline in credit quality from the date of origination to

> **Observation:** The definition of a PCD asset under Topic 326 is broader than the definition of a purchased credit impaired (PCI) asset under prior GAAP in Subtopic 310-30, Receivables — Loans and Debt Securities Acquired with Deteriorated Credit Quality. A PCD asset has experienced a "more than insignificant" credit deterioration since origination. Under prior GAAP, an asset was not considered a PCI asset unless it was probable that cash flows would not be collected on the asset. Topic 326 does not include a probability threshold. Therefore, more assets may qualify as PCD assets under Topic 326.

the date of acquisition. Under Topic 326, PCD assets are subject to a gross-up approach. That is, for a PCD asset, the amortized cost basis at initial measurement reflects the sum of the estimated expected credit losses at the purchase date, plus its purchase price.

An entity must record an allowance for expected credit losses for PCD assets on the acquisition date.

Under Topic 326:

- On the date of acquisition, an entity must recognize an allowance for expected credit losses. PCD assets typically are purchased at a discount. The allowance for expected credit losses represents the portion of the discount due to expected credit losses.
- The allowance is added to the purchase price on the date of acquisition to determine the initial amortized cost basis of the asset. In other words, the balance sheet is grossed up for the credit impairment.
- An entity does not record credit loss expense on the acquisition date. In other words, there is no income statement effect on the acquisition date.
- Subsequent changes in the allowance (after the acquisition) are recorded in income.
- Due to a subsequent recovery, an entity may record a negative allowance for a PCD asset measured at amortized cost (but not for an available-for-sale debt security).

> **Observation:** Topic 326 requires an allowance to be recorded for both PCD assets and non-PCD assets. This treatment is intended to make it easier for users of the financial statements to compare and analyze PCD assets and non-PCD assets.

Observation: Purchased financial assets with credit deterioration generally are acquired at a discount. The discount relates to both expected credit losses and other factors — such as changes in market interest rates. The discount related to expected credit losses is recognized as an allowance on the acquisition date. The remaining discount is recorded as interest income over the life of the asset. An entity does not recognize interest income for the discount related to expected credit losses.

Figure 6 illustrates the accounting for a PCD asset on the acquisition date. This figure uses the following assumptions:

- An entity buys a PCD asset that has a par value of $100,000.
- The purchase price is $60,000.
- The entity determines that the discount of $40,000 relates to:
  - Expected credit losses of approximately $32,000.
  - Changes in market interest rates and other factors ($8,000).

Figure 6 — Initial Journal Entry for PCD Asset

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General ledger account	Debit	Credit
Loan — par value	$100,000	
Loan — noncredit discount		$8,000
Allowance for credit losses		$32,000
Cash		$60,000
Total	$100,000	$100,000

Observation: The main difference between PCD assets and non-PCD assets is the effect on the income statement on the date of acquisition. When an entity acquires a PCD asset, there is no income statement effect on the acquisition date. When an entity acquires a non-PCD asset, the entity records credit loss expense on the acquisition date; the credit loss expense represents the entity's estimate of expected credit losses over the life of the asset.

In subsequent periods, the noncredit discount is accounted for as interest income and accreted into income over the life of the asset. Also, the allowance for credit losses must be remeasured each reporting period. Any changes in the allowance after the acquisition date are recorded in income as credit loss expense.

Beneficial Interests

Since the introduction of Topic 326, an entity is also required to record an allowance for expected credit losses for beneficial interests under Subtopic 325-40, Investments — Other — Beneficial Interests in Securitized Financial Assets. The allowance is measured using a discounted cash flow (present value) technique.

An entity must account for a beneficial interest as a PCD asset if either of the following is true:

- The beneficial interest meets the definition of a PCD asset.
- At the date of recognition, there is a significant difference between the contractual and expected cash flows.

If an entity is required to account for a beneficial interest as a PCD asset, it applies the following guidance:

- Subtopic 326-20, Financial Instruments — Credit Losses — Measured at Amortized Cost, for beneficial interests classified as held-to-maturity.
- Subtopic 326-30, Financial Instruments — Credit Losses — Available-for-Sale Debt Securities, for beneficial interests classified as available-for-sale.

The SEC may periodically release additional guidance pertinent to the accounting and financial reporting of credit losses. Registrants must familiarize themselves with any applicable SEC rules and regulations.

Reminders for SEC Registrants

The SEC reviews each registrant's filing at least once every three years. As part of this review, the SEC often pays close attention to new accounting standards and complex accounting matters. As such, Topic 326 and the accounting for credit losses is expected to be an area of SEC focus for some time.

An SEC comment letter may challenge or request additional information about an entity's application of Topic 326. For instance, recent SEC comment letters have asked registrants about:

- The effects of COVID-19 on an entity's financial statements, including the allowance for credit losses.
- The methods and assumptions used to estimate expected credit losses.
- The use of forecasts under Topic 326, including how an entity reverts back to historical loss information beyond a reasonable and supportable forecast period.
- The omission of one or more required disclosures under Topic 326.
- The use of practical expedients or accounting policy elections under Topic 326.
- An entity's initial adoption of Topic 326, including the timing, financial statement effects, and an entity's compliance with the transition provisions.

The SEC may periodically release additional guidance pertinent to the accounting and financial reporting of credit losses. Registrants must familiarize themselves with any applicable SEC rules and regulations. For instance, the SEC discusses its expectations regarding the accounting for loan losses under Topic 326 in Staff Accounting Bulletin (SAB) Topic 6.M, Financial Reporting Release No. 28—Accounting for Loan Losses by Registrants Engaged in Lending Activities Subject to FASB ASC Topic 326. This includes the SEC's expectations for measuring expected credit losses as well as developing, governing, documenting, and validating a systematic methodology to account for those losses.

Comparison to Prior U.S. GAAP

The original source of Topic 326 was Accounting Standards Update (ASU) No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.

The following table summarizes the main improvements in Topic 326 and how the model in Topic 326 compares to prior GAAP in effect before the issuance of ASU No. 2016-13.

Figure 7 — Main Improvements in Topic 326

Improvement	Description
Moving to an expected loss model	Topic 326 uses an expected loss model to account for credit losses. Prior GAAP used an incurred loss model to account for the impairment of financial instruments. The incurred loss model included the concept of an "other-than-temporary impairment" and recorded a loss when the loss was probable. Critics of the incurred loss model asserted that it delayed the recognition of credit losses in an entity's financial statements. The expected loss model in Topic 326 generally results in the earlier recognition of credit losses. Under Topic 326, an entity no longer waits for a loss to be probable before the loss is recognized. Instead, an entity records an allowance that reflects management's current estimate of expected credit losses over the life of the asset. In theory, Topic 326 affects the timing (but not the total amount) of credit losses recognized when compared to prior GAAP. In moving to an expected loss model, Topic 326 may require an entity to apply a larger degree of judgment as part of its impairment assessment.
Requiring the use of forecasts	Topic 326 expanded the information considered to estimate expected credit losses. Topic 326 requires an entity to estimate expected credit losses using information about past events, current conditions, and reasonable and supportable forecasts. To estimate incurred losses under prior GAAP, an entity only considered past events and current conditions, but not forecasts.
Improving the accounting for purchased financial assets with credit deterioration	Topic 326 made the accounting for purchased financial assets with credit deterioration (PCD assets) more consistent with the accounting for other financial instruments. Topic 326 requires an entity to record an allowance for credit losses for an asset regardless of whether the asset is purchased or originated. Under Topic 326, an allowance is recorded on the day that a PCD asset is purchased. Under prior GAAP, no allowance was recorded on the day that a financial asset with credit deterioration was purchased.

Improvement	Description
Enhancing disclosures	Although many of the disclosure requirements in Topic 326 are similar to prior GAAP, Topic 326 does include some new or enhanced disclosures. For instance, Topic 326 requires a public business entity to disclose credit quality information for assets by vintage (year of origination). This disclosure is intended to provide users of the financial statements with better information about an entity's underwriting standards. Similar to prior GAAP, the disclosures in Topic 326 generally must be provided by portfolio segment, class of financial assets, or major security type.
Requiring credit losses on available-for-sale debt securities to be recorded through an allowance	Under Topic 326, credit losses on an available-for-sale debt security must be recorded through an allowance. If the issuer's credit improves in a subsequent period, an entity must adjust the allowance to reflect the improvement. The use of an allowance permits changes in an issuer's credit (both improvements and deteriorations) to be reflected in an entity's income statement in the periods in which the changes occur. Under prior GAAP, an entity recorded credit losses as a write down to an available-for-sale debt security and could not adjust the security for subsequent improvements in the issuer's credit.

Topic 326 introduced other smaller changes related to prior GAAP. For instance, Subtopic 326-20 requires an entity to estimate expected credit losses on a collective (pool) basis for assets with similar risk characteristics. This may result in evaluating held-to-maturity securities on a pool basis, even though these securities were evaluated separately for impairment under prior GAAP.

Comparison to IFRS 9

Differences exist between the FASB and IASB models to account for expected credit losses on financial instruments.

The IASB's principles for expected credit losses are laid out in IFRS 9. At a high level, the approach uses a dual-measurement objective for expected credit losses — one measurement for assets having experienced a significant increase in credit risk since origination, and a separate measurement for assets that have not experienced such credit deterioration.

Under IFRS 9, if an asset (or group of assets) has not experienced a significant increase in credit risk since origination, an entity estimates expected credit losses over the next 12 months of the asset's life. If an asset (or a group of assets) has experienced a significant decline in credit quality, an entity must estimate expected credit losses over the asset's lifetime.

Topic 326, on the other hand, uses a single measurement objective in which an entity records its total estimate of expected credit losses on a financial asset at origination. This is the main difference between Topic 326 and IFRS 9.

Since the FASB and the IASB have introduced different impairment models, there will be differences in the accounting for expected credit losses under U.S. GAAP and IFRS. A primary difference is the partial estimate of lifetime expected credit losses for financial instruments that have not experienced a significant increase in credit risk since origination under IFRS 9. Under IFRS 9, the allowance for these assets is based on 12 months of expected credit losses. Under U.S. GAAP, however, the allowance is based on lifetime expected credit losses. Therefore, the allowance recorded for this category of assets under IFRS 9 likely will be less than the allowance recorded under U.S. GAAP.

Another notable difference is the fact that IFRS 9 explicitly requires an entity to consider the time value of money when estimating the amount of expected credit losses. U.S. GAAP does not require an entity to adjust its estimate for the time value of money. The IFRS standard also requires an entity to use a probability-weighted measurement that considers various scenarios and the likelihood of each scenario occurring. These specific measurement requirements can potentially cause an IFRS entity and a U.S. GAAP entity to compute different amounts of expected credit losses for an identical asset.

Tips for Companies that Have Not Yet Adopted Topic 326

Companies that have not yet adopted Topic 326 have substantial work that must be completed to prepare for implementation. For instance, here are a few activities that these companies must consider:

- **Collect data to measure expected credit losses:** Collection of data is a critical starting point for implementation. A company must collect sufficient data to be able to project expected credit losses over the life of the asset. A company may already be collecting some of the data necessary, but must develop processes to accumulate any additional data required to estimate the allowance for expected credit losses. A company also must establish proper controls around the data.
- **Determine estimation methods:** Determining the appropriate methods to estimate expected credit losses is a key implementation decision. The standard provides flexibility for management to identify a method that is reasonable and meets the objectives of the standard. A company may be able to leverage existing systems or worksheets that were used to account for impairment under prior GAAP. If a company chooses this approach, it still must add any new inputs to the analysis necessary to estimate expected credit losses. For instance, prior GAAP required an entity to consider information about past events and present conditions to account for impairment. Topic 326 requires an entity to consider not only past events and present conditions, but also reasonable and supportable forecasts. Therefore, an entity that decides to leverage existing systems and worksheets must make enhancements to incorporate forecasts into its estimate of expected credit losses. A company also may wish to implement estimation methods that will allow for revisions and improvements in future periods.

Applying Topic 326 is not a "set it and forget it" exercise. Reporting entities must ensure they have proper processes and controls in place to comply with Topic 326 on an ongoing basis.

- **Evaluate the new disclosure requirements:** Providing adequate disclosure is another essential piece to the successful implementation of a new standard. Some companies may use highly sophisticated models to estimate expected credit losses and it may be a challenge for them to prepare disclosures that adequately explain their estimation methods. Also, the standard requires some new disclosures, which will take time to draft. As part of this effort, a company must ensure it gathers and maintains the information needed to prepare the required disclosures under Topic 326.
- **Disclose the anticipated effects of the new standard:** SEC registrants must disclose the expected effects of recently issued accounting standards in accordance with Staff Accounting Bulletin (SAB) Topic 11.M, Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period (commonly referred to as SAB 74). For instance, private companies looking to go public must be aware of the rules for SEC registrants. In part, SAB Topic 11.M requires an entity to disclose the potential material effects of Topic 326 when adopted. If an entity cannot reasonably estimate the effects, it must disclose this fact, the status of its implementation (including significant items outstanding) and qualitative information to help users evaluate the possible effects.
- **Involve other departments:** Employees from various functions of the business (such as accounting, finance, risk management and IT) may be heavily involved in the implementation of Topic 326 and the ongoing processes and controls necessary to comply with the guidance in periods following adoption. Therefore, these employees must understand the requirements under Topic 326 and their roles and responsibilities in ensuring that the company is compliant with the requirements. An entity also is encouraged to engage the tax department to understand and prepare for any tax consequences of the standard on the entity's financial statements.
- **Establish ongoing processes and controls:** Applying an accounting standard is not a "set it and forget it" exercise. Reporting entities must ensure they have proper processes and controls in place to perform the ongoing estimates and calculations required by Topic 326, as well as comply with the ongoing disclosure and financial reporting requirements. Controls must address the completeness, accuracy, validity, and restricted access of the information used in accounting for credit losses under Topic 326. Companies may wish to engage outside specialists and auditors to evaluate the sufficiency of their processes and controls as they prepare for implementation of Topic 326. Processes and controls also must be assessed and tested periodically to ensure they are functioning as intended.

The FASB set up a transition resource group (TRG) for credit losses to help address issues that constituents have in implementing Topic 326.

Based on stakeholder feedback, the TRG made various recommendations to the FASB regarding the application of Topic 326, which resulted in amendments and technical corrections to Topic 326 through Accounting Standards Updates (ASUs). Those ASUs are incorporated into this special report as appropriate. The TRG continues to exist, but its pace of activities has slowed as more companies complete their transition to Topic 326. The FASB also released Staff Q&A documents on the use of forecasts and the Weighted Average Remaining Maturity (WARM) Method to help stakeholders in applying Topic 326.

The FASB continues its Post-Implementation Review (PIR) Process, which is designed to review the implementation efforts of entities that have already adopted Topic 326 and other major accounting standards. More information on the FASB's PIR process is available on the FASB's website. Stakeholders are encouraged to reach out to the FASB with questions regarding their implementation of the standard. Entities are also encouraged to reach out to the FASB (and the SEC) with questions about the effects of the COVID-19 pandemic on implementation and disclosures.

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