JULY 2019

STAFF Q&A

TOPIC 326, NO. 2

DEVELOPING AN ESTIMATE OF EXPECTED CREDIT LOSSES ON FINANCIAL ASSETS

PURPOSE OF THIS STAFF Q&A

This FASB staff Q&A only focuses on the guidance in Topic 326, Financial Instruments—Credit Losses. This Q&A does not address other regulatory, rules, or compliance requirements that entities may need to consider when preparing and issuing financial statements.

Topic 326 contains a requirement of applying a reasonable and supportable forecast and, if applicable, reverting to historical loss information (if an entity is unable to forecast credit losses over the estimated life of the instrument) when measuring expected credit losses. As part of the Board's continuing commitment to educate stakeholders, the staff has developed this question and answer (Q&A) document to respond to some frequently asked questions about using historical loss information, developing reasonable and supportable forecasts, and requirements regarding applying the reversion to historical loss information. The staff encourages entities also to read the Staff Q&A Topic 326, No. 1, *Whether the Weighted-Average Remaining Maturity Method Is an Acceptable Method to Estimate Expected Credit Losses*, that was issued in January 2019.

For contextual purposes, this Q&A includes information from Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, and certain paragraphs in the basis for conclusions.

Update 2016-13 was developed to be operably scalable and flexible. An entity must apply judgment in estimating expected credit losses. An entity's estimate of expected credit losses should reflect its expectations or its best estimate of expected credit loss. All examples or numerical adjustments contained in this Q&A are intended for educational purposes. Consequently, numerical adjustments should not be misconstrued as a "starting point," that is, a required amount or the Board's expectation regarding the level of allowance for expected credit losses that a particular entity should record.

BACKGROUND

When an entity develops an estimate of expected credit losses for financial assets held at amortized cost at the reporting date, Topic 326 requires the entity to consider available and relevant information, including historical experience, current conditions, and reasonable and supportable forecasts, with the objective of presenting the entity's estimate of the net amount expected to be collected on the financial assets. Under this new accounting standard, an entity should use reasonable and supportable forecasts to inform stakeholders about its credit loss estimates. The amendments in the Update do not require a specific credit loss estimation method; an entity is allowed to use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances over the reasonable and supportable period.

An entity is required to disclose information that will help users of financial statements understand its method and relevant information used to develop the allowance for credit losses, including information on its reasonable and supportable forecasts.

Questions have been posed to the staff on acceptable approaches for determining reasonable and supportable forecasts and techniques for reverting to historical loss

information when developing an estimate of expected credit losses on financial assets.

Paragraph 326-20-30-7 of Topic 326 states:

> When developing an estimate of expected credit losses on financial asset(s), an entity shall consider available information relevant to assessing the collectibility of cash flows. This information *may include internal information, external information, or a combination of both* relating to past events, current conditions, and reasonable and supportable forecasts. An entity shall consider relevant qualitative and quantitative factors *that relate to the environment in which the entity operates and are specific to the borrower(s).* When financial assets are evaluated on a collective or individual basis, *an entity is not required to search all possible information that is not reasonably available without undue cost and effort.* Furthermore, an entity is not required to develop a hypothetical pool of financial assets. *An entity may find that using its internal information is sufficient in determining collectibility.* [Emphasis added.]

BASIS FOR CONCLUSIONS

Paragraph BC47 of Update 2016-13 states that "in considering current conditions and [reasonable and supportable] forecasts about the future, an entity should consider both the [current] economic environment and the forecasted direction of the economic environment because that best reflects the economic environment facing the borrower as of the reporting date."

Paragraph BC50 states that:

> The Board acknowledges that any approach to estimating the collectibility of financial assets is subjective. The Board has permitted entities to estimate expected credit losses using various methods because the Board believes entities manage credit risk differently and should have flexibility to best report their expectations. The Board recognizes that different methods may result in a range of acceptable outcomes. Given the subjective nature of this estimate and certain fact patterns, one methodology's consideration of time value may have a more direct impact on the estimate of expected credit losses than other methods. Some entities may be able to forecast over the entire estimated life of an asset, while other entities may forecast over a shorter period. The complexity of the portfolio, size of the entity, access to information, and management of the portfolio may result in approaches with varying degrees of sophistication. Because entities may have different levels of sophistication, the Board did not prescribe one type of methodology for measuring expected credit losses for financial assets measured at amortized cost. The Board concluded that different outcomes for expected credit losses due to these and other factors are acceptable under the amendments in this Update. Furthermore, using terms such as *reasonable* and *supportable* does not imply a single conclusion or methodology upon which an entity must base its estimate. Different parties using different methodologies [with different outcomes] do not make a particular estimate unreasonable. While the range of reasonable outcomes is not unlimited, the Board concluded that it is rare that there will only be one acceptable choice in estimating credit losses. . . .

Paragraph BC52 states that "the Board recognizes that as the forecast horizon increases, the degree of judgment involved in estimating expected credit losses also increases because the availability of detailed inputs to estimates for periods in the future decreases. An entity should not ignore available information that is relevant to the estimated collectibility of the reported amount."

QUESTIONS AND ANSWERS—GENERAL QUESTIONS ABOUT THE CECL STANDARD

Question 1

Does the application of the word *forecast* in paragraph 326-20-30-7 infer computer-based modeling analysis is required?

Response

No, developing forecasts does not require an entity to perform computer-based modeling. Topic 326 allows a quantitative or a qualitative adjustment to be made when assessing current conditions and reasonable and supportable forecasts. One way to apply a forecast on a qualitative basis is by using qualitative factors (Q-factors). Similar to how many entities consider Q-factors under existing practice in determining the allowance for credit losses, another approach can be used for forecasting.

Question 2

If an entity's actual credit losses differ from its estimate of expected credit losses, is it required to modify its forecasting methodology?

Response

The Board notes that estimates of expected credit losses often will not predict with precision actual future events. The objective of the amendments in the Update is for entities to present their best estimate of the net amount expected to be collected on financial assets. The amendments do not require a specific loss method; rather,

an entity is required to use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances. The Board understands that there generally is a range of reasonable outcomes and, therefore, expects there to be differences between estimates of expected credit losses and actual credit losses. Ultimately, estimates of future losses and actual losses should converge to the same amount. An entity should continue to refine future estimates of expected credit losses based on actual experience. For example, if actual results indicate that macroeconomic conditions are having a greater or lesser effect than originally projected, an entity may need to adjust future loss projections to reflect this change.

QUESTIONS AND ANSWERS—HISTORICAL LOSS INFORMATION

Question 3

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

Response

No. The guidance states that an entity should not rely solely on past events to estimate expected credit losses. When an entity uses historical loss information to forecast expected credit losses, it should consider the need to adjust historical loss information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical loss information was evaluated. The adjustments, if needed, to historical loss information may be qualitative or quantitative in nature and should reflect changes related to relevant data.

In addition, an entity should consider adjustments to historical loss information for differences in current asset-specific risk characteristics, such as underwriting standards, portfolio mix, or asset term within a pool at the reporting date. An entity also should consider whether historical loss information used covers a sufficient time period such that it reflects the term of the financial asset or group of financial assets.

Question 4

How should an entity determine which historical loss information to use when estimating expected credit losses?

Response

In determining what historical loss period information best represents the financial assets, an entity may use historical loss information that is nonsequential (such as historical loss percentages based for each year since origination as opposed to an average 5-year historical loss percentage). The appropriate historical loss period can vary between loan portfolios, products, pools, and inputs. An entity should consider both the appropriate historical period and the appropriate length of the period when developing those estimates.

An entity should use judgment in determining which period or periods to consider when determining which historical loss information is most appropriate for estimating expected credit losses. An entity does not have to use historical losses from the most recent periods. For example, an entity may determine that the historical loss information that best represents the specific risk characteristics of the entity's current portfolio relates to periods from 20X2–20X5. Using the historical loss information from 20X2–20X5 as an input to the measurement of expected credit losses, an entity would then consider how current conditions and reasonable and supportable forecasts affect the estimate of expected credit losses. Once the historical period has been chosen, an entity should consider adjustments to historical loss information for differences in current asset specific risk characteristics, such as underwriting standards, portfolio mix, or asset term within a pool at the reporting date or when an entity's historical loss information does not reflect the contractual term of the financial asset or group of financial assets. For periods beyond the reasonable and supportable forecast period, an entity should revert to historical loss information that may not be from the same period used to estimate its reasonable and supportable forecast and should reflect the contractual term of the financial asset or group of financial assets. In other words, an entity should use historical loss information that is more reflective of the remaining contractual term of the financial assets for periods beyond the reasonable and supportable forecast period.

QUESTIONS AND ANSWERS—REASONABLE AND SUPPORTABLE

Question 5

Is an entity required to consider all sources of available information when estimating expected credit losses?

Response

No, an entity is not required to consider all sources of available information. Paragraph 326-20-30-7 states that "an entity is not required to search all possible information that is not reasonably available without undue cost and effort." Therefore, an entity should consider relevant information that is reasonably available that can be obtained without undue cost and effort. An entity should not ignore available information that is relevant to the estimated collectibility of the reported

amount. This should not be interpreted to mean that an entity must always default to using only external data (for example, consensus forecasts) if its internal data is sufficient and more appropriate in the circumstances.

For example, external data may be available for purchase, but an entity may conclude that obtaining that information will result in an undue cost and to review the external information and incorporate this external information into the entity's processes will require too much effort, when internal information is sufficient in determining collectibility. Therefore, the entity could develop an estimate of expected credit losses on financial assets using internal data only.

Alternatively, an entity may have limited internal data for a particular portfolio to estimate the collectibility of the reported amount. Therefore, the entity will need to rely on external data for the purposes of developing an estimate of expected credit losses.

Question 6

What if external data are not costly, but internal data are more relevant to an entity's loss calculation? Is the entity required to obtain and/or use the external data?

Response

No. Certain facts and circumstances may arise for which internal data more appropriately capture the credit-quality risk for a specific entity than external data. Internal data may be more useful in estimating expected credit losses than external data because an entity may have captured more information that is unique to its business and the communities in which it operates than what can be captured from an external resource.

For example, in a recession, one or more portfolio segments may experience significant losses. While there may be publicly available data, such as volume of permits granted, there also may be internal data, such as profit margins which can be correlated to losses. Therefore, an entity may choose to rely on trends from internally gathered metrics, assuming the portfolio size is sufficient, on its own customer base rather than publicly available data in determining expected credit losses.

As another example, an entity may obtain information that indicates a substantial local community water contamination issue. This information could suggest a decline in property values, which could increase an entity's estimate of expected credit losses. The guidance allows an entity to use judgment in estimating expected credit losses, which includes the flexibility to decide which information should be used in estimating expected credit losses (internal or external data or a combination of both).

Question 7

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

Response

Paragraph 326-20-30-7 states "when developing an estimate of expected credit losses on financial asset(s), an entity shall consider available information relevant to assessing the collectibility of cash flows." The guidance goes on to state that "information may include internal information, external information, or a combination of both." The guidance does not prescribe what type of information can be used in developing an estimate of expected credit losses as long as that information is relevant to the entity, which means that 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. However, if an entity does not have the internal information that would be relevant to developing expected credit losses, it should consider external information to develop an estimate of expected credit losses. Similarly, an entity that has relevant internal information may rely on that information without acquiring or referencing external information. An entity is not required to search all possible information that is not reasonably available without undue cost and effort.

Question 8

May the length of reasonable and supportable forecast periods vary between different portfolios, products, pools, and inputs?

Response

Yes. The duration or length of the reasonable and supportable forecast period is a judgment that may vary based on the entity's ability to estimate economic conditions and expected losses. The reasonable and supportable forecast may vary between portfolios, products, pools, and inputs. However, specific inputs (such as unemployment rates) should be applied on a consistent basis between portfolios, products, and pools, to the extent that the same inputs are relevant across products and pools. It also is acceptable to have a single reasonable and supportable period for all of an entity's products. An entity is to disclose information that will enable users to understand management's method for developing its expected credit losses, the information used in developing its expected credit losses, and the circumstances that caused changes to the expected credit losses among other disclosures about the allowance for credit losses.

Question 9

Does an entity need to include the full contractual period (adjusted for prepayments) in its estimate of the reasonable and supportable forecast period?

Response

No. Some entities may be able to apply reasonable and supportable forecasts over the estimated contractual term (that is, the contractual term adjusted for prepayments). However, the guidance does not require an entity to develop forecasts over the contractual term (adjusted for prepayments) of the financial asset or group of financial assets (paragraph 326-20-30-9).

For example, three separate lenders, each based in three different communities, loaned money to borrowers employed by a manufacturer that has operations in three separate communities. Many borrowers in each of the three communities are employed by one of the manufacturing plants in their community. The manufacturer has announced plans to close one of its manufacturing plants in 18 months. However, it is not yet known which plant the manufacturing company will close. Each entity should apply judgment in developing reasonable and supportable forecasts when considering the effect of a possible plant closure on its ability to collect any principal and interest on outstanding loan balances from those borrowers who work at this plant. Each of the three entities may have different estimates of expected credit losses, including the inputs, assumptions, or durations for their reasonable and supportable forecast period. For example, entities may be able to reasonably forecast losses beyond the period of the plant closure or may determine that their forecasts are reasonable only up to the period of the plant closure.

Another example is when a wholesaler has short-term receivables from a retailer in a local mall that is experiencing financial difficulty. This wholesaler may be able to forecast all expected credit losses on the receivable, and, therefore, the reasonable and supportable forecast period would include the contractual term of the receivable.

Question 10

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

Response

Yes. An entity should consider the appropriateness of its reasonable and supportable forecast period, as well as other judgments applied in developing estimates of expected credit losses each reporting period. If the reasonable and supportable period does not cover the full expected contractual term (adjusted for prepayments), an entity should consider the appropriateness of the duration of its reversion period (that is, the periods beyond the reasonable and supportable period) and the methodology applied when reverting back to historical loss information. For example, an entity may determine that it is appropriate to shorten or lengthen its reasonable and supportable forecast period from prior periods because of changes in the uncertainty of some or all of the inputs and assumptions used to measure expected credit losses.

Question 11

Is an entity required to correlate reasonable and supportable forecasts to macroeconomic data, such as nationwide or statewide data?

Response

No. An entity is not required to correlate or reconcile reasonable and supportable forecasts to macroeconomic data, such as the national unemployment rate. Instead, when developing an estimate of expected credit losses on financial assets, the entity should consider available information relevant to assessing the collectibility of cash flows.

For example, a business closure may not correlate to any macroeconomic phenomena. Instead, an entity may decide to move to another state to receive a more lucrative tax treatment. In this instance, the macroeconomic factors may indicate a very strong job market with low nationwide or statewide unemployment rates, but the business closure may have a significant effect for the entity in the local economic environment when assessing the collectibility of amounts owed by its borrowers. In this instance, correlating a local economic event to macroeconomic data may not be appropriate because the macroeconomic data are not relevant.

In other instances, an entity may consider whether a national trade agreement will have a favorable or unfavorable effect on its ability to collect contractually owed cash flows from its borrowers. The entity may decide to review its internal information that has not indicated any changes in employment to date, but based on a government decision, there may be an effect on the entity's local economy that will result in a change to expected credit losses.

Question 12

When developing a reasonable and supportable forecast to estimate expected credit losses, is probability weighting of multiple economic scenarios required?

Response

No. Topic 326 does not require an entity to probability weight multiple economic scenarios when developing an estimate of expected credit losses. One entity may choose to probability weight multiple economic scenarios when developing its estimate of expected credit losses, while another entity may rely on a single economic scenario to develop reasonable and supportable forecasts.

Question 13

Is there a standard threshold that can be used to adjust historical loss information? For example, in the most recent FASB Staff Q&A, Topic 326, No. 1, *Whether the Weighted-Average Remaining Maturity Method Is an Acceptable Method to Estimate Expected Credit Losses* (Q&A 1), the staff assumed a 0.25 percent qualitative adjustment to represent both current conditions and reasonable and supportable forecasts.

Response

No, there is no specific standard threshold regarding adjustments for current conditions and reasonable and supportable forecasts. The objective of Topic 326 is to present an entity's estimate of the net amount expected to be collected on the financial asset or group of financial assets. The standard does not require a specific credit loss method; rather, it requires that an entity use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances. This includes adjustments to historical loss information for current conditions and reasonable and supportable forecasts. The 0.25 percent adjustment used in Q&A 1 was an example of one way to incorporate a qualitative adjustment for both current conditions and reasonable and supportable forecasts. How management quantified the qualitative adjustment was not highlighted in the example.

QUESTIONS AND ANSWERS—REVERSION TO HISTORICAL LOSS INFORMATION

Question 14

What should an entity do if it cannot forecast estimated credit losses over the entire contractual term (adjusted for prepayments)?

Response

An entity is not required to develop forecasts over the entire contractual term (adjusted for prepayments) of the financial asset or group of financial assets. For periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, it is required to revert to historical loss information that reflects expected credit losses during the remainder of the contractual term (adjusted for prepayments) of the financial asset or group of financial assets.

Update 2016-13 provides entities with flexibility to determine the expected credit losses and does not require an entity to develop reasonable and supportable forecasts for the entire expected remaining life of a loan (that is, contractual term adjusted for prepayments), such as a 30-year mortgage. Therefore, the Board included guidance on how an entity should estimate expected credit losses for those periods beyond the reasonable and supportable forecast period. The periods after the reasonable and supportable forecast periods are often referred to as the "reversion period" and "post-reversion period," as applicable. When reverting to historical loss information, an entity should (1) consider whether the historical loss information is still relevant to estimating expected credit losses (that is, in accordance with paragraph 326-20-30-8, an entity may consider adjusting its historical loss information for differences in current asset-specific risk characteristics) and (2) not adjust historical loss information in the reversion period and post-reversion periods for existing economic conditions or expectations of future economic conditions.

Question 15

Can an entity adjust the historical loss information used in the reversion period for existing economic conditions or expectations of future economic conditions when developing estimates of expected credit losses?

Response

No. For periods beyond which an entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, it should revert to historical loss information determined in accordance with paragraph 326-20-30-8 that reflects expected credit losses during the remainder of the contractual term (adjusted for prepayments) of the financial asset or group of financial assets. The entity should not adjust historical loss information for existing economic conditions or expectations of future economic conditions for periods that are beyond the reasonable and supportable period.

The Board decided to require that an entity revert to historical loss information without adjusting historical loss information for economic conditions beyond the reasonable and supportable period to simplify the estimation process. However, this historical loss information should be adjusted for differences in current asset-specific risk characteristics in accordance with paragraph 326-20-30-8. The Board understands that an entity may need additional guidance on how to measure

expected credit losses as it estimates losses in periods of increasing uncertainty and decreasing precision. The reversion to an entity's historical loss information emphasizes the relevance of known loss experience that has occurred in the past on similar financial assets or groups of financial assets and addresses preparers' concerns about the reliability of estimating those credit losses in periods of declining precision.

Question 16

Is an entity required to revert to historical loss information on a straight-line basis?

Response

No. Although an entity is required to revert to historical loss information for periods that cannot be forecasted based on reasonable and supportable information, the Board did not prescribe a single methodology for reverting to historical loss information. Instead, the Board stated that an entity may revert to historical loss information immediately on a straight-line basis or using another rational and systematic basis. In addition, the guidance permits an entity to apply different reversion methods for different inputs and asset classes.

The Board understands that an entity may need additional guidance on how to measure expected credit losses as it estimates losses in periods of increasing uncertainty and decreasing precision. The reversion to an entity's historical loss information emphasizes the relevance of known loss experience that has occurred in the past on similar financial assets and addresses preparers' concerns about the reliability of estimating those credit losses in periods of declining precision.

Ultimately, an entity should use judgment in determining which reversion technique is most appropriate at the reporting date. For example, an entity identifies that a factory in its local economy will be closing in two years. As part of the entity's reasonable and supportable forecast, it considers the effect the closure will have on collecting its outstanding loan balances. The expected contractual term (adjusted for prepayments) of remaining loans exceeds the two-year reasonable and supportable forecast period, and, therefore, the entity will need to revert to historical loss information. The entity decides to apply a straight-line technique when reverting to historical loss information because the factory closing will continue to affect the collectibility of outstanding loan balances for periods beyond the reasonable and supportable forecast period. In this instance, it may not be appropriate to immediately revert to historical loss information because there may be a prolonged effect on the entity's ability to collect on contractually owed cash flows because employees of the factory may be unemployed for a long time. Alternatively, an entity may capture the extended impact of the closure in its qualitative adjustments.

In contrast, an immediate reversion methodology could be appropriate when an entity may be able to develop a reasonable and supportable forecast only for a market-based input (such as home prices) that covers one year.

The reversion method is not a policy election but rather a component of the overall estimate of expected credit losses. Like other components used to measure expected credit losses, an entity should support the reversion methodology and period it uses to develop its estimates of expected credit losses. Additionally, reversion to historical loss information, whether immediately or on a straight-line basis or using another reasonable methodology, is required only for periods that cannot be forecasted based on reasonable and supportable information.

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