PacificCPE

COURSE
21601A

# New Credit Loss Allowance Rules Overview

Get up to speed on the latest credit loss standards, including ASU 2016-13 and the recently issued ASU 2025-05 and ASU 2025-08. This introductory course walks through the background of financial instrument projects, the expected credit loss model under ASC 326-20, and key amendments affecting accounts receivable, contract assets, and purchased loans. Whether you work in financial reporting or advise clients on accounting standards, this course gives you a solid foundation for understanding how the new rules work and what has changed.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

Start Course ↓ | Final Exam Copy ↓

## LEARNING ASSIGNMENTS AND OBJECTIVES

### Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

### Course Objectives

- Recognize examples of assets that are and are not subject to the ASC 326-20 expected credit loss model.
- Recognize the model that ASU 2016-13 uses to deal with credit losses.
- Recall how an entity should present the new allowance for credit losses on the balance sheet.
- Identify examples of entities that are under common control.
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Identify how a decline in a held-to-maturity debt security is accounted for.

- Recognize the new impairment model for available-for-sale debt securities under ASC 326-30.
- Recognize some new and not new disclosures under ASU 2016-13.
- Recognize two elections that can be made under ASU 2025-05.
- Recall how subsequent collections of trade receivables are measured in the year-end allowance balance.

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## TABLE OF CONTENTS


CHAPTER 00

**New Credit Loss Allowance Rules** ..... 5

0.01 I. Objective ..... 6

0.02 II. Background ..... 6

0.03 III. Asu 2016-13 Amendments ..... 12

0.04 IV. Asc 326-20 Expected Credit Loss Model ..... 12

0.05 Comparison Of Expected Credit Loss Model (Asu 2016-13) ..... 19

0.06 V. Asu 2025-05: Financial Instruments—Credit Losses (Topic 326) Measurement Of Credit Losses For Accounts Receivable And Contract Assets ..... 35

0.07 VI. Asu 2025-08: Financial Instruments—Credit Losses (Topic 326) Purchased Loans ..... 43

Test Your Knowledge ..... 45

**Final Exam Copy** ..... 60

**Glossary** ..... 50

# NEW CREDIT LOSS ALLOWANCE RULES

*Chapter Objective*

**After completing this course, you should be able to:**

- Recognize examples of assets that are and are not subject to the ASC 326-20 expected credit loss model.
- Recognize the model that ASU 2016-13 uses to deal with credit losses.
- Recall how an entity should present the new allowance for credit losses on the balance sheet.
- Identify examples of entities that are under common control.
- Identify how a decline in a held-to-maturity debt security is accounted for.
- Recognize the new impairment model for available-for-sale debt securities under ASC 326-30.
- Recognize some new and not new disclosures under ASU 2016-13.
- Recognize two elections that can be made under ASU 2025-05.
- Recall how subsequent collections of trade receivables are measured in the year-end allowance balance.

**Issued:** June 2016

**Effective date:** ASU 2016-13 is effective as follows:

The FASB has delayed the effective date of ASU 2016-13 to the following:

- For public business entities that are SEC filers: the amendments in the ASU are effective for fiscal years beginning after December 15, 2019, including interim periods within those annual periods. For all other public business entities, the amendments are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.
- For all other entities, including nonpublic entities, not-for-profit entities, and employee benefit plans on plan accounting: the amendments in the ASU are effective for fiscal years beginning after December 15, 2022 (calendar year 2023), and interim periods within those fiscal years.

Early application is permitted.

## I. OBJECTIVE

The primary objective of ASU 2016-13 is to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date.

## II. BACKGROUND

### A. PREVIOUS GAAP- INCURRED LOSS MODEL (PRE-2023)

Previous GAAP used various credit impairment models with respect to financial instruments. The objective of such models has been to delay recognition of credit losses until the loss was probable and reasonably estimated (the "incurred loss" model). Under the "incurred loss" model, recognition is delayed until it is probable a loss has been incurred and the amount must be reasonably estimated.

1. ASC 310-10, Receivables, uses the contingency rules to determine when an allowance for doubtful accounts on receivables is required.
2. ASC 450-20-25-2, *Contingencies- Loss Contingencies*, requires recognition of an allowance for credit losses on receivables when both of the following conditions are met under the incurred loss model:
   a) Information available before the financial statements are issued or is available to be issued indicates that it is probable that an asset has been impaired at the date of the financial statements.
   b) The amount of the loss can be reasonably estimated.
3. The two conditions (probable and reasonably estimated) may be considered in relation to individual receivables or in relation to groups of similar types of receivables.
4. If the two conditions are met, accrual is made even though the particular receivables that are uncollectible may not be identifiable.
5. Under the incurred loss model, it is inappropriate to consider possible or expected future trends or forecast information that may lead to additional losses.

| *Note* |
| --- |
| Under the incurred loss model, if at the balance sheet date, it is not probable that a loss has been incurred and the loss cannot be reasonably estimated, the loss cannot be recorded in the allowance account. |

6. The incurred loss model limits the amount of losses that can be recorded in the allowance account to those that are probable and estimable at the balance sheet date.

    a) An entity can use actual accounts or historical percentages to determine the probable and reasonably estimated criteria.

    b) The incurred loss model cannot consider future or forecasted information that is expected to occur after the balance sheet date unless it existed at the balance sheet date.

**Example- limitations of the incurred loss model:**

- Bad debts on receivables occurring after the balance sheet date cannot be included in the year-end allowance balance unless the uncollectibility existed at the year-end balance sheet date.
- Loans expected to become uncollectible after the balance sheet date cannot be included in the year-end allowance balance unless they were uncollectible at the balance sheet date.

**Example 1: Previous (pre-2023) Incurred Loss Model- Trade Receivables**

**Facts:**

Company X has a trade receivable due from Customer Z in the amount of $1,000,000 at December 31, 20X1.

As of December 31, 20X1, it is not probable that there is a credit loss related to the $1,000,000.

On March 1, 20X2, Z's plant is wiped out due to a hurricane, and the $1,000,000 is uncollectible.

X uses the incurred loss model to record an allowance on its trade receivables.

**Conclusion:**

Under the incurred loss model, at 12-31-X1, X is not permitted to record an allowance of $1,000,000 due to Z's hurricane damage.

At 12-31-X1, it is not probable that a loss was incurred, and the amount cannot be reasonably estimated.

The incurred loss model requires that the allowance be recorded based on historical data and information that existed at 12-31-X1.

The impact of the hurricane that created uncollectibility on March 1, 20X2 is a future event that cannot be considered in determining the allowance account at 12-31-X1.

X may wish to disclose the uncollectibility as a Type 2 subsequent event but may not record the loss in the allowance account at 12-31-X1.

**Example 2: Previous Incurred Loss Model for Loan Portfolio**

**Facts:**

X bank has a loan portfolio with various tranches of consumer and real estate loans with terms ranging from 5 to 30 years.

Total loan balances equal $5,000,000.

At December 31, 20X1, X wishes to record an allowance for losses for its loan portfolio.

At December 31, 20X1, X can identify $200,000 of loans for which it is probable that a loss has been incurred and X can reasonably estimate the amount.

In addition, X expects that, based on statistical data, approximately $400,000 of additional performing loans at 12-31-X1 will become uncollectible sometime after 12-31-X1 during the future 5- to 30-year period.

**Conclusion:**

In recording its 12-31-X1 allowance, X can only consider historical information, whereby at 12-31-X1, it is probable that a loss has been incurred and X can estimate the amount of the loss.

Under the previous incurred loss model, X is not permitted to consider changes in economic conditions and future forecasted events occurring after 12-31-X1 through maturity of the various loans, in estimating The New Allowance for Credit Losses.

Thus, X should record an allowance in the amount of $200,000. X is not permitted to record the additional $400,000 based on losses it expects will occur in the future because those losses did not exist at the 12-31-X1 balance sheet date.

**Problem with the incurred loss model**

The incurred loss model has significant limitations, which can result in overstated receivables and an understated allowance account. According to the FASB:

a. Financial institutions and other financial statement users have stated concerns that the previous "probable threshold" GAAP approach limits an entity's ability to record credit losses that the entity expects to occur, but have not yet met the "probable" threshold.

b. Entities seek to replace the "probable" approach with one that assesses an entity's allowance for credit losses (e.g., allowance for bad debts):

- Using forward-looking information, and
- Based on the entity's own internal expectations.

During the global financial crisis, there was an inconsistency as to the timing of estimating credit losses versus recording those losses:

1. For management purposes, financial statement users were estimating expected credit losses and devaluing investments based on forward-looking information.
2. For GAAP, entities were recording losses using the incurred loss model based on a probable and reasonably estimated threshold.
3. Because of the lag in recording losses using the previous GAAP "probable" threshold model, GAAP assets have been overstated as they do not reflect the true net collectible amount.

**Examples:**

- During the 2008 financial crisis, banks could not record an allowance for bad loans that did not exist at year-end, but became uncollectible after year-end.
- On December 31, 2019 balance sheets, companies were precluded from recording an allowance on loans and trade receivables that became uncollectible in early 2020 due to the COVID shutdowns.

**FASB-IASB 2008 project commences**

In 2008, the FASB and the International Accounting Standards Board (IASB) established a Financial Crisis Advisory Group (FCAG) to advise both boards on improvements to financial reporting in response to the earlier financial crisis. The FCAG did the following:

1. It identified as a weakness in current GAAP under which there was delayed recognition of credit losses that has resulted in the potential of overstated assets.
2. The FCAG recommended exploring more forward-looking alternatives to the incurred loss methodology.

The project resulted in the June 2016 issuance of ASU 2016-13, Financial Instruments– Credit Losses *(Topic 326) Measurement of Credit Losses on Financial Instruments*.

On the international standards front, the International Accounting Standards Board (IASB) had previously issued its own financial instruments standard, IFRS 9, Financial Instruments.

ASU 2016-13 does the following:

- Eliminates major portions of previous ASC 310, Receivables
- Creates new ASC 326, Financial Instruments- Credit Losses
- Moves large portions of ASC 310 into new ASC 326, Financial Instruments- Credit Losses
- Amends ASC 320 with respect to impairment of available-for-sale debt securities, and

• Amends various other ASC sections.

**B. NEW ASC 326, FINANCIAL INSTRUMENTS- CREDIT LOSSES**

1. ASU 2016-13 adds new ASC 326 to provide guidance on how an entity should measure credit losses on financial instruments using the new expected credit loss model[1].
   a) ASC 326-10- provides general guidance on the new expected credit loss model.
   b) ASC 326-20- provides specific guidance on use of the expected credit loss model for financial instruments measured at amortized cost and certain other financial instruments.
   c) ASC 326-30- provides guidance on modifications to the impairment model for available-for-sale debt securities.
2. The new ASC 326 applies to all entities.

**C. RECENT FASB ASUS TARGETED AT ASC 326'S CREDIT LOSSES**

Since the issuance of ASU 2016-13, the FASB has issued further guidance in the form of additional ASUs most of which are targeted at narrow issues related to credit losses. Following is a chart that summarizes recent ASUs issued specifically related to ASU 2016-13: