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June 2025

On the Radar

Current Expected Credit Losses

ASC 326 provides comprehensive guidance on recognizing and measuring credit losses related to financial assets measured at amortized cost (e.g., held-for-investment loans and held-to-maturity [HTM] debt securities), net investments in leases, reinsurance recoverables, certain off-balance-sheet credit exposures (e.g., certain loan commitments), and available-for-sale (AFS) debt securities. The CECL impairment model, which is based on expected losses, applies to all of the above except AFS debt securities, which are subject to a different model. The objectives of the CECL model are to:

- Increase the consistency of the credit impairment model applied to debt instruments.
- Ensure timely recognition of credit losses through use of an expected loss model that requires an entity to recognize an allowance of lifetime expected credit losses.
- Provide flexibility by not requiring entities to use a specific method in estimating expected credit losses.

Guidance Applies to More Than Just Banks

Although the CECL standard was more relevant to banks, most nonbanks have financial instruments or other assets (e.g., trade receivables, contract assets, lease receivables, financial guarantees, loans and loan commitments, and HTM debt securities) that are subject to the CECL model.

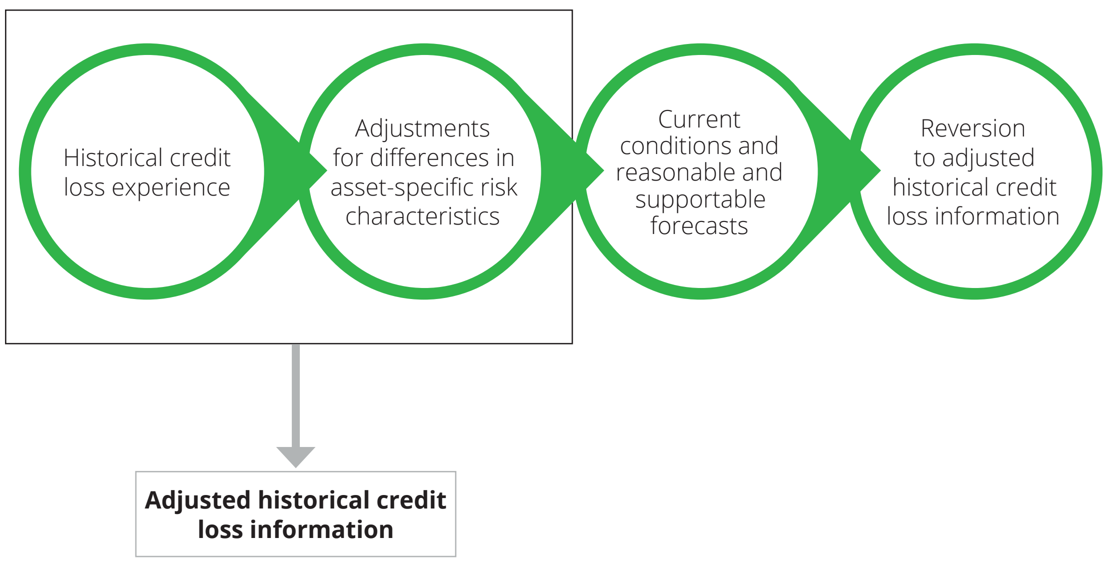
Consistent Impairment Models

As noted above, the CECL model is consistently applied to recognize and measure credit losses related to financial assets measured at amortized cost, net investments in leases, reinsurance recoverables, and certain off-balance-sheet credit exposures; the credit impairment model for AFS debt securities is separate. Assets measured at fair value (e.g., trading securities) or under lower-of-cost-or-market models (e.g., mortgage loans held for sale) are not subject to separate credit loss guidance since credit losses are reflected in the measurement models that apply to such assets.

Expected Losses Versus Incurred Losses

The CECL model does not specify a threshold for recognizing an impairment allowance. Rather, an entity recognizes its estimate of expected credit losses for financial assets as of the end of the reporting period. Credit impairment is recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset.

An entity's estimate of expected credit losses should reflect the losses that occur over the contractual life of the financial asset. When determining the contractual life of a financial asset, an entity is required to consider expected prepayments either as a separate input in the method used to estimate expected credit losses or as an amount embedded in the credit loss experience that it uses to estimate such losses. The entity is not allowed to consider expected extensions of the contractual life unless extensions are a contractual right of the borrower.



An entity must consider all available relevant information when estimating expected credit losses, including details about past events, current conditions, and reasonable and supportable forecasts and their implications with respect to expected credit losses. That is, while the entity can use historical charge-off rates as a starting point for determining expected credit losses, it has to evaluate how conditions that existed during the historical charge-off period may differ from its current expectations and accordingly revise its estimate of expected credit losses. However, the entity is not required to forecast conditions over the contractual life of the asset. Rather, for the period beyond the period for which the entity can make reasonable and supportable forecasts, the entity reverts to historical credit loss experience.

No Prescribed Method

The CECL model reflects *management's* expectations regarding the net amounts expected to be collected on a financial asset. Because entities manage credit risk differently, they have flexibility when reporting those expectations under ASC 326. As a result, ASC 326 does not require entities to use a specific method when measuring their estimate of expected credit losses. Accordingly, an entity can select from a number of measurement approaches to determine the allowance for expected credit losses. Some approaches project future principal and interest cash flows (i.e., a discounted cash flow [DCF] method), while others project only future principal losses. ASC 326 emphasizes that an entity should use methods that are "practical and relevant" given the specific facts and circumstances and that "[t]he method(s) used to estimate expected credit losses may vary on the basis of the type of financial asset, the entity's ability to predict the timing of cash flows, and the information available to the entity."

Although the method used to measure expected credit losses may vary for different types of financial assets, the method used for a particular financial asset should be consistently applied to similar financial assets.

The table below summarizes various measurement approaches that an entity could use to estimate expected credit losses under ASC 326.

Measurement Approach	High-Level Description
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 for bad debts on trade receivables.

Looking Ahead

The FASB has continued its postimplementation review of ASC 326 to assess whether the standard is achieving its objective. As part of this process, the Board is considering stakeholder input and feedback, along with other research, to determine whether improvements could be made.

In addition, the FASB has issued proposed ASUs that would:

- Broaden the population of financial assets that are within the scope of the gross-up approach currently applied to PCD assets under ASC 326.
- Introduce a practical expedient, and, for certain entities, an accounting policy election.

See Deloitte's Roadmap *Current Expected Credit Losses* for comprehensive discussions related to ASU 2016-13, including the highlights of the recently issued ASU 2022-02 that eliminates the accounting guidance on TDRs for creditors and amends the guidance on vintage disclosures.

Contacts

Andrew Pidgeon
Audit & Assurance
Partner
Deloitte & Touche LLP
+1 415 783 6426
apidgeon@deloitte.com

For information about Deloitte's offerings on CECL for commercial entities, please contact:

Will Braeutigam
Audit & Assurance
Partner
Deloitte & Touche LLP
+1 713 982 3436
wbraeutigam@deloitte.com

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