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Effects of ASC 326 Current Expected Credit Loss Standard (CECL) for Non-Financial Institutions
FASB Release No. 2016-13; (Issue Date: June 16, 2016)
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Overview

On June 16, 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-13, *Measurement of Credit Losses on Financial Instruments*, which introduces Current Expected Credit Losses (CECL). The update is effective beginning January 2023 for non-SEC filers, smaller reporting companies and privately held companies. SEC filers have the option of postponing adoption of the CECL standard until the earlier of:

- The end of the national emergency declaration related to the COVID-19 crisis, or
- December 31, 2022

CECL was issued due to a perceived need to consider expected losses over a financial asset's life at inception. In particular, the FASB wanted to improve the recognition of measurement of credit losses on loans and debt securities for financial institutions, however, the scope of CECL is far broader. It includes, but is not limited to, the following:

- Trade Receivables
- Note Receivables
- Receivables that relate to repurchase agreements
- Loans to officers and employees
- Contract assets
- Loans to equity affiliates
- Guarantees
- Cash Equivalents

Accounting for CECL

As previously mentioned, the new guidance represents a shift from recognition of incurred losses to cumulative expected losses. Previous guidance delays recognition of credit losses until an incurred loss is probable, whereas CECL requires the recognition of credit losses as soon as the losses become "expected" rather than "probable". The period of evaluation for expected losses considered should be the contractual term of the asset. Under CECL, entities must now consider current economic conditions and reasonable future forecasting, in addition to historical losses under the old method. Additionally, pooling is required and is based on assets sharing similar circumstances. The following example adapted from ASU 2016-13 shows the application of CECL to trade receivables.

Current Model

Company A has $20 million of trade receivables. Under the old standard, their allowance of $2.5 million is based on aging at period end using historical loss rates as follows:

- 0% reserve for the current receivables of $10 million
- 6% for receivables that are 1-30 days past due of $5 million
- 28% for receivables that are 31-60 days past due of $3 million
- 49% for receivables that are 61-90 days past due of $1 million
- 87% for receivables that are more than 90 days past due of $1 million

Application of New Model

As previously mentioned, under the new model expected credit losses factor in current conditions and future expectations, therefore, it is entirely possible to have a reserve for current assets. Due to the historic market volatility associated with COVID-19, it is possible that companies may need to increase their reserve rate under CECL, to account for uncertain current and future economic conditions. Using the same facts as above, Company A has $20 million in trade receivables, only this time they apply CECL. Due to weakened current and forecasted future economic conditions, such as increased unemployment, Company A has an updated allowance of $2.8 million based on the following aging schedule:

- 2% reserve for the current receivables of $10 million
- 7% for receivables that are 1-30 days past due of $5 million
- 29% for receivables that are 31-60 days past due of $3 million
- 50% for receivables that are 61-90 days past due of $1 million
- 88% for receivables that are more than 90 days past due of $1 million

As an added wrinkle to the new model, CECL requires that receivables sharing similar risk characteristics be pooled together. In the case of trade receivables, companies should determine whether their current segmentation practices are consistent with the requirement to pool financial assets with similar risk characteristics. For example, Company A may determine it is appropriate to pool by region, type, and aging. Under CECL, management could group their receivables similar to the table below and then apply the expected loss rates. Entities must consider whether loss rates need to be adjusted for specific asset pools, or if the loss rates can be applied universally across all asset pools within the same aging class.

Geography	Type	Current	1-30 Days	31-60 Days	61-90 Days	> 90 Days
North America	Large Retailers	$ XX	$ XX	$ XX	$ XX	$ XX
	Small Retailers	$ XX	$ XX	$ XX	$ XX	$ XX
Europe	Large Retailers	$ XX	$ XX	$ XX	$ XX	$ XX
	Small Retailers	$ XX	$ XX	$ XX	$ XX	$ XX
Asia	Large Retailers	$ XX	$ XX	$ XX	$ XX	$ XX
	Small Retailers	$ XX	$ XX	$ XX	$ XX	$ XX

The Anticipated Effects

Entities should first write a policy outlining how CECL will be applied, including assumptions and method used to calculate loss reserves. Additionally, the policy should outline how CECL differs from applying previous guidance, and what go-forward process changes will occur due to CECL. For example, entities should assess current and future economic conditions on a periodic basis (best practice is quarterly). Application of CECL to short-term receivables is not expected to differ significantly from current practice. However, it is expected that most entities will recognize losses earlier under CECL than they would under current GAAP. Furthermore, entities need to determine if an allowance should be recognized even for current receivables that are not yet past due. Entities will apply this update through a cumulative-effect adjustment to retained earnings (i.e., a modified-retrospective approach).

The standard allows entities freedom in how to forecast future economic conditions, so long as the methods used are both “reasonable and supportable”. Due to the uncertain nature around forecasting future economic conditions, we expect there to be variation in how the application of the ASU will impact different entities. For example, when Wells Fargo implemented CECL at the beginning of 2020, it reported a $1.3 billion **reduction** in its allowance for credit losses under CECL. The bank subsequently added $3 billion to its reserves in Q1’2020 as the global pandemic began to take way. In Q2’2020, the bank announced a further $8.4 billion addition to its loss reserves, stating that their “view of the length and severity of the economic downturn has deteriorated considerably from the assumptions used last quarter, which drove the $8.4 billion addition to our credit loss reserve in the second quarter." Consequently, the ASU may lead to the unintended consequence of less standardization and comparability across organizations, as each organization can apply the future forecasting how they see fit, with assumptions potentially changing drastically from one period to the next.

Guarantees – Potential Sleeper issue

One item that may be overlooked by companies when applying CECL are guarantees, such as letters of credit. These do not include guarantees that fall under the scope of other accounting standards, such as lessee guarantee of residual value, a guarantee issued by an insurance entity, or a guarantee accounted for as a credit derivative. If the guarantee is in the scope of CECL, then the CECL guidance requires an additional credit loss estimate to be recognized for the lifetime expectation of credit loss payments to be made under the guarantee, starting at the inception.

Impact of COVID-19 on CECL

Originally scheduled to be effective after December 15, 2019 for SEC filers, CECL implementation has now been delayed a third time under the Consolidated Appropriations Act (CAA), signed into law on December 27, 2020. This is due to the volatile and unpredictable environment created by COVID-19, leading to an inability to reasonably predict future losses. Entities are lacking the historical data to replicate the current financial landscape. It will take some time for entities to sufficiently obtain the data needed to assess economic factors and to apply these to CECL calculations. However, some entities decided to move forward with CECL implementation in 2020, due to significant investments already in place leading up to the original adoption date. These entities are likely to report larger credit reserves to account for greater expected credit losses.

Final Thoughts

In general, CECL can be summarized as follows:

- It is a paradigm shift from current losses to expected losses
- Most significant impact on financial service entities but all companies will be affected on some level
- Implementation considerations are broad due to number of assets that need to be considered
- Pooling is required, and assets that share similar risk characteristics should be pooled together

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It is our view that the CECL standard is not necessarily introducing a new accounting requirement as the expectation has always been to reflect only the value of receivables expected to be collected, however it does force more focus on considering forward looking expectations. We further believe this is another accounting standard that addresses management judgment, a consistent theme in recent accounting standards.

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Contact
Jason C. Evans | Managing Principal, Accounting & Finance

1001 Old Cassatt Road | Suite 200 | Berwyn, PA 19312
2001 Market Street | Suite 3230 | Philadelphia, PA 19102
jevans@fidatopartners.com | 610 246 7091 (c)

www.fidatopartners.com
https://www.linkedin.com/in/jason-evans-36059628/

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