CECL IS JUST FOR FINANCIAL INSTITUTIONS, RIGHT?

By John Griffin

Effective for public companies in 2020 and others in subsequent years is a new accounting standard that has become a widely discussed subject for the banking industry. The buzz surrounding the new accounting standard – commonly referred to as the current expected credit loss (CECL) standard – primarily stems from how it changes the accounting for the allowance from loan and lease losses from an incurred loss model to a life of loan loss concept.

Accounting Standards Codification (ASC) 326, *Financial Instruments – Credit Losses*, added by Accounting Standards Update 2016-13 (Topic 326), has been a hot topic in the financial services industry since its issuance in June 2016. However, this standard isn't just for financial institutions. It's broad in scope and affects entities holding loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables and any other financial assets carried at amortized cost[1], not excluded from the scope that have the contractual right to receive cash.

1 As defined in ASC 326, the amortized cost basis is the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion or amortization of premium, discount, and net deferred fees or costs, collection of cash, write offs, foreign exchange and fair value hedge accounting adjustments.

This article examines trade receivables and investments, as many entities outside of financial institutions hold these types of financial assets.

Trade Receivables

Trade receivables or traditional accounts receivable related to the sale of goods are considered within the scope of Topic 326. So how does transitioning to a lifetime loss estimate affect trade receivables? As a starting point, the standard setters provided an example – Example 5 – of how Topic 326 could be implemented for entities holding trade receivables.

Example 5: Estimating Expected Credit Losses for Trade Receivables Using an Aging Schedule (as illustrated in ASC 326)

Facts: Entity E manufactures and sells products to a broad range of customers, primarily retail stores. Customers are typically provided with payment terms of 90 days with a 2% discount if payments are received within 60 days. Entity E has tracked historical loss information for its trade receivables and compiled the following historical credit loss percentages:

Past-Due Status	Historical Loss %
Current	0.3%
1-30 days past due	8%
31-60 days past due	26%
61-90 days past due	58%
More than 90 days past due	82%

Entity E believes this historical loss information is a reasonable base on which to determine expected credit losses for trade receivables held at the reporting date, because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit loss percentages. (That is, the similar risk characteristics of its customers and its lending practices haven't changed significantly over time.)

However, Entity E has determined that the current and reasonable and supportable forecasted economic conditions have improved as compared with the economic conditions included in the historical information. Specifically, Entity E has observed that unemployment has decreased as of the current reporting date and Entity E expects there will be an additional decrease in unemployment over the next year.

To adjust the historical loss rates to reflect the effects of those differences in current conditions and forecasted changes, Entity E estimates the loss rate to decrease by approximately 10% in each age bucket. Entity E developed this estimate based on its knowledge of past experience for which there were similar improvements in the economy.

At the reporting date, Entity E develops the aging schedule shown in Table 1 to estimate expected credit losses.

Based on this example provided in the guidance, the methodology isn't unlike how many calculate the reserve for uncollectible accounts, except that consideration must now be given for future periods and how economic conditions affect that outlook. The guidance is clear that an entity shall not rely solely on past events to estimate expected credit losses. The entity should adjust historical 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 information was evaluated.

A key consideration with respect to trade receivables is the type of business and customer owing the outstanding debt. For many companies, the short-term nature of a majority of receivables will likely result in very few differences to today; however, the longer the life of the trade receivable, the more consideration should be given to what could happen after the end of a period.

The customer's ability to repay should be tied to some economic variable that can better estimate expected losses. An entity should consider all relevant qualitative and quantitative factors that relate to the environment in which the entity operates and are specific to the borrower(s).

TABLE 1. AGING SCHEDULE

Past Due Status	Amortized Cost Basis	Historical Loss Rate	Adjustment	Credit Loss Rate	Expected Credit Loss Estimate
Current	$5,984,698	0.3%	(0.03%)	0.27%	$16,159
1-30 days past due	8,272	8%	(0.8%)	7.2%	596
31-60 days past due	2,882	26%	(2.6%)	23.4%	674
61-90 days past due	842	58%	(5.8%)	52.2%	440
More than 90 days past due	1,100	82%	(8.2%)	73.8%	812
	$5,997,794				$18,681

Investments

Many entities hold investments in debt securities, and Topic 326 changes how an entity measures and when it recognizes credit losses for these holdings. The potential effect for each entity depends on if the investments are classified as held-to-maturity (HTM) or available-for-sale (AFS).

The most significant change to investments under Topic 326 is the inclusion of HTM debt securities under the CECL model of the standard. An entity must consider its estimate of expected lifetime credit losses on pools of similar risk or individual HTM debt securities. This is a substantial shift from current generally accepted accounting principles (GAAP), which only require analysis of potential credit loss if the security's fair value is less than the amortized cost basis.

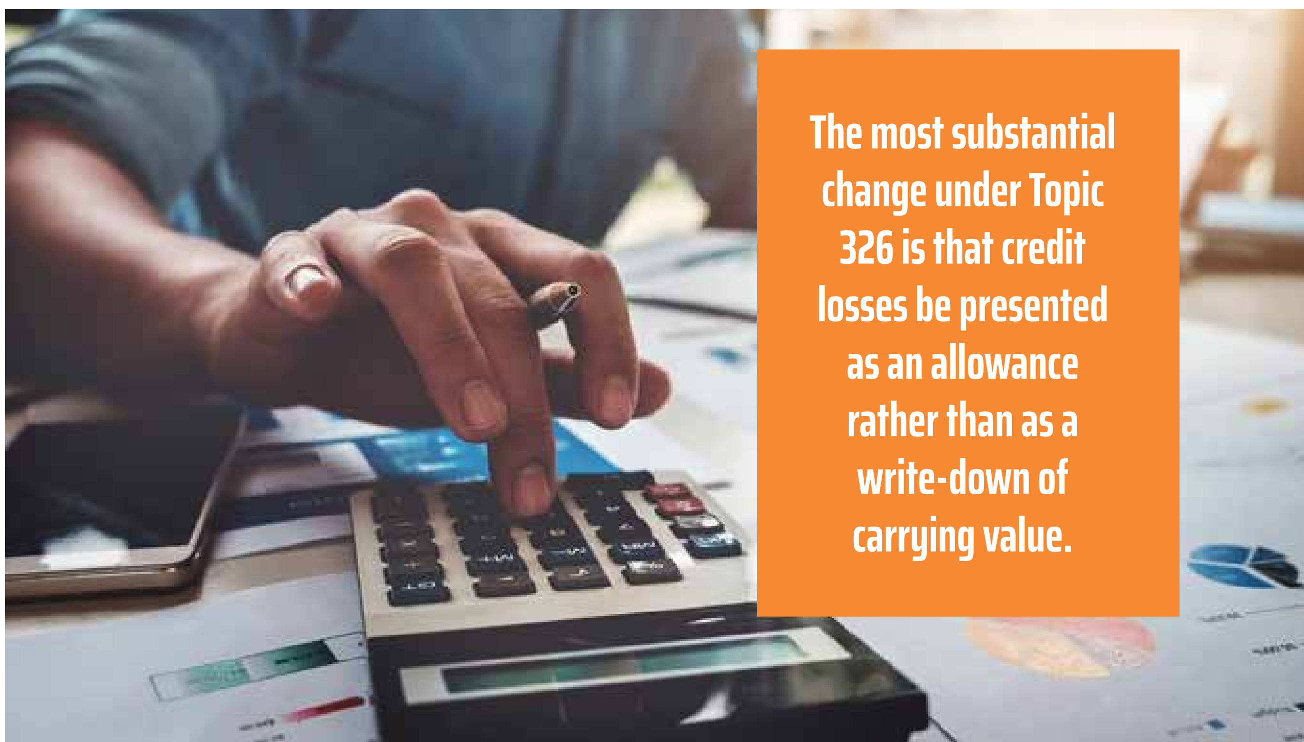
In addition, an entity must determine expected credit loss even if risk of credit loss is remote. It's not the most likely outcome that matters under CECL, but the potential for loss. The standard doesn't prescribe specific debt securities that would have zero expectation of loss; however, there are circumstances, such as U.S. Department of the Treasury (Treasury) and government agency securities, where the potential for default could be greater than zero, but expected nonpayment is zero. In this case, the long history with no credit losses for Treasury securities indicates an expectation that nonpayment of the amortized cost basis is zero, even if the U.S. government were to technically default.

This is considered appropriate, as these securities are explicitly fully guaranteed by a sovereign entity that can print its own currency and that entity's currency is:

- Routinely held by central banks and other major financial institutions;
- Used in international commerce;
- Commonly viewed as a reserve currency, all of which qualitatively indicate that historical credit loss information should be minimally affected by current conditions and reasonable and supportable forecasts.

Credit losses on AFS debt securities should be measured in a manner similar to current GAAP. Although the length of time that an investment's fair value is less than the amortized cost is no longer a factor, a company should consider certain factors in determining whether a decline in fair value below the amortized cost basis has resulted from credit loss or some other reason. The factors include:

- The extent to which the fair value is less than the amortized cost basis;
- Adverse conditions specifically related to the security, an industry or geographic area; for example, changes in the financial condition of the issuer of the security or, in the case of an asset-backed debt security, changes in the financial condition of the underlying loan obligors; examples of those changes include any of the following:
  - Changes in technology;
  - The discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security;
  - Changes in the quality of the credit enhancement;
- The payment structure of the debt



The most substantial change under Topic 326 is that credit losses be presented as an allowance rather than as a write-down of carrying value.

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security and the likelihood of the issuer being able to make payments that increase in the future;

- Failure of the issuer of the security to make scheduled interest or principal payments;
- Any changes to the rating of the security by a rating agency.

As stated in the ASC 326-30-35-6, "In assessing whether a credit loss exists, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If the present value of cash flows expected to be collected is less than the amortized cost basis of the security, a credit loss exists and an allowance for credit losses shall be recorded for the credit loss, limited by the amount that the fair value is less than amortized cost basis. Credit losses on an impaired security shall continue to be measured using the present value of expected future cash flows."

As such, the most substantial change under Topic 326 is that credit losses be presented as an allowance rather than as a write-down of carrying value. This is an improvement in current GAAP, as it allows for immediate recovery of previously recorded losses when credit loss expectations improve.

In addition, as Topic 326 removes the ability to consider the length of time a security is in an unrealized loss position when determining whether a credit loss exists, this could increase the likelihood of recording an allowance under the new standard when you otherwise wouldn't have recorded an other-than-temporary impairment under current GAAP, as duration is a main consideration in assessing impairment.

Assessment Needed

This standard affects all entities, not just financial institutions. If an entity holds loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables and any other financial assets not excluded from the scope that have the contractual right to receive cash, then this standard will apply. Although the standard isn't applicable for a few years, entities should assess their holdings and determine if this standard will be applicable.

The complexity of implementing the standard depends on the type of holdings. Data and disclosure requirements may need to be adjusted.

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