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CECL Considerations for Non-Banking Companies

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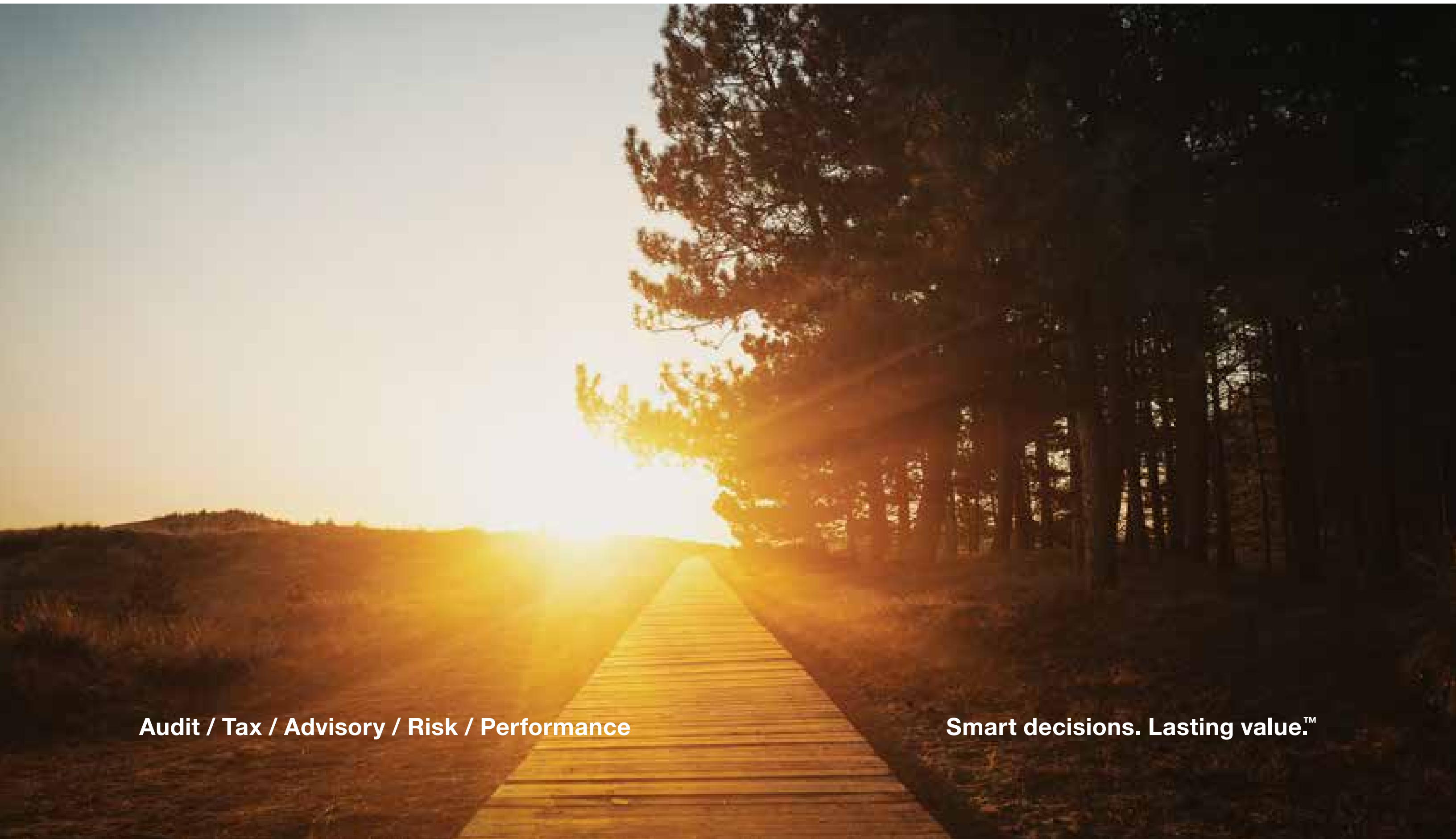

What is CECL?

CECL refers to the Financial Accounting Standards Board's (FASB's) new credit impairment standard, Accounting Standards Update (ASU) 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. CECL addresses how to account for credit impairment on certain financial assets, like loans and certain debt securities.

Wait, doesn't CECL just apply to banking institutions?

No. In fact, CECL applies to all entities. While CECL will likely have the greatest impact on banks (which typically have extensive financial instrument portfolios), even non-banking entities are very likely to hold financial instruments within the scope of CECL.

What types of instruments are within the scope of the new CECL guidance?

CECL applies to all entities and generally applies to all financial instruments measured at amortized cost, with a few exceptions. For entities other than traditional financial institutions (e.g., depository institutions such as banks or credit unions), typical items held by these entities that might fall within the scope of CECL include:

INSTRUMENT TYPE	CECL IMPACT(S)
Trade receivables – receivables and contract assets recognized under Topic 606, *Revenue from Contracts with Customers*.	While generally short term in nature, receivables and contract assets are still subject to CECL when estimating an entity's allowance for bad debt expense.
Loans and loan commitments – for example, loans provided to officers, employees, or customers that are accounted for under Topic 310, *Receivables* or other than unconditionally cancelable loan commitments.	When an entity recognizes a loan at amortized cost, it will be subject to CECL. Similarly, losses arising from other than unconditionally cancelable (off balance sheet) loan commitments are to be measured using CECL and recognized as a liability.
Reinsurance receivables – for example, a receivable recognized by an insurer or a captive insurance entity for amounts recoverable under a reinsurance agreement.	While these receivables generally result from insurance transactions within the scope of Topic 944, *Financial Services—Insurance*, entities outside the insurance industry may also have these receivables (e.g., a commercial entity that offers insurance through a captive insurance entity).
Available-for-sale (AFS) debt securities – for example, government or corporate debt securities classified by an entity as AFS.	While AFS debt securities are not subject to the new expected credit loss model, CECL did slightly amend the impairment model for AFS debt securities (see discussion further below).
Held-to-maturity (HTM) debt securities – for example, government or corporate debt securities classified by an entity as HTM.	Because these items are carried at amortized cost, they will be subject to CECL.
Net investment in sales-type, direct-financing, and leveraged leases – for example, any receivable arising from an entity's lessor-related activities other than under an operating lease.	CECL will require entities to recognize an allowance for credit losses on net investments in sales-type, direct-financing, and leveraged leases accounted for under Topic 840, *Leases*, or Topic 842, *Leases*.
Financial guarantees (other than those that are accounted for as insurance or as a derivative) – for example, an entity's guarantee of a non-consolidated entity's debt.	While the financial guarantee will still be subject to Topic 460, *Guarantees*, entities will also be required to apply CECL to estimate the expected credit losses arising from the guarantee.
Other	CECL will also apply to items such as store credit card receivables, insurance settlements, tax refunds, etc.

How might CECL impact me?

The following table summarizes some of the key changes resulting from CECL that will likely affect non-banking entities:

KEY CHANGE	POTENTIAL IMPACT
Replacement of the "probable incurred loss" concept with "expected losses"	Under CECL, an entity no longer waits for the occurrence of a triggering event before recognizing an allowance for credit losses (e.g., notification of a customer's financial difficulty). Rather, an entity will recognize an allowance for expected lifetime losses upon initial recognition of the asset. This will result in entities recognizing credit losses earlier under CECL as compared to current practice.
Expansion of information set used to measure credit losses	Under CECL, an entity must consider not only historical loss information and current conditions when estimating its allowance but also reasonable and supportable forecasts about future conditions. That is, CECL requires a more forward-looking estimate as compared to current practice, which generally has focused primarily on historical loss information and current conditions. This will likely require changes to an entity's process and surrounding controls for estimating credit losses as historical loss information and current conditions will need to be compared against reasonable and supportable forecasts about future conditions (e.g., expected changes in unemployment rates).
Requirement to reflect risk of loss in estimate, even if remote	Under CECL, an entity's estimate of expected credit losses must reflect the risk of credit loss, even when that risk is deemed remote. While CECL does acknowledge that there may be circumstances in which the potential for default exists but expected loss is zero – for example, U.S. Treasury securities[1] – it is expected to be uncommon for other types of instruments.
Revisions to the impairment model for AFS debt securities	Under CECL, the expected credit loss model only applies to financial instruments measured at amortized cost. However, CECL also amends the existing impairment model for AFS debt securities, including in the following ways: • Prohibits entities from considering the length of time a security has been in a loss position when determining whether a credit loss exists. • Prohibits entities from considering subsequent recoveries or declines in fair value after the balance sheet date when estimating credit losses. • Requires credit losses (and recoveries) to be recognized through an allowance against the security's carrying amount (versus as a direct reduction against the carrying amount).
Incremental disclosure requirements	CECL requires extensive disclosure about an entity's estimate of expected credit losses, including information about the entity's estimation methodology, relevant risk factors, and changes in significant inputs. CECL also requires a quantitative rollforward of an entity's allowance for credit losses and, for most financing receivables, disclosure of credit quality indicators.[2] Depending on the nature and amount of items an entity has within the scope of CECL, entities may need to implement new processes and controls to gather and summarize the information required under the new disclosures.

[1] ASC 326-20-55-48 indicates that a U.S. Treasury security is not the only instrument for which an entity may estimate a potential default of greater than zero, but an estimated nonpayment of zero. However, this outcome is expected to be uncommon.

[2] ASC 326-10-50-9 exempts entities from having to provide information about credit quality indicators for trade receivables due in one year or less (except for credit card receivables).

Can you share an example of how CECL might affect the accounting for trade receivables?

The following example highlights how CECL might affect an entity's current practice of estimating an allowance for bad debt for trade receivables.

Facts

At year-end, Widget Co. has on its balance sheet trade receivables with a gross carrying amount of $50 million. The aging schedule for the outstanding receivables as of year-end is as follows:

CURRENT BALANCE	31-60 DAYS OUTSTANDING	61-90 DAYS OUTSTANDING	91-120 DAYS OUTSTANDING	121+ DAYS OUTSTANDING
$37 million	$9.5 million	$2.7 million	$0.5 million	$0.3 million

Historically, Widget Co. has estimated its allowance for bad debts by applying historical loss rates to each aging category. Using 12 months of historical credit sales and collections data, Widget Co. has calculated historical loss rates for each aging category as follows:

CURRENT BALANCE	31-60 DAYS OUTSTANDING	61-90 DAYS OUTSTANDING	91-120 DAYS OUTSTANDING	121+ DAYS OUTSTANDING
0%	3%	7%	23%	100%

Based on the above rates, under current GAAP, Widget Co. would recognize an allowance for bad debt expense equal to $0.89 million.

However, under CECL, the historical loss rate must account for reasonable and supportable forecasts of future losses. For example, assume that during the last quarter, unemployment rates have increased, and it is expected that unemployment rates will increase even further over the next twelve months. In addition, under CECL, the allowance should reflect the risk of loss – including for current or not yet due receivables – even if the risk of loss is remote.

Based on the changes in unemployment rates and the future expected changes, as well as the need to incorporate the risk of loss in its estimation, Widget Co. believes its historical loss rate for each aging category will need to be adjusted upward, consistent with the historical impact increases in the unemployment rate have had on Widget's allowance. As a result, Widget Co. would adjust its estimate of its allowance for bad debt expense to reflect the expected impact of the change in unemployment rate as follows:

	CURRENT BALANCE	31-60 DAYS OUTSTANDING	61-90 DAYS OUTSTANDING	91-120 DAYS OUTSTANDING	121+ DAYS OUTSTANDING
$ AMOUNT	$35 million	$9.7 million	$2.7 million	$0.5 million	$0.3 million
HISTORICAL LOSS RATE	0%	3%	7%	23%	100%
LOSS RATE ADJUSTED FOR FUTURE CONDITIONS	1.15%	3.36%	8.05%	27.6%	100%
ADJUSTED ALLOWANCE	$0.426 million	$0.319 million	$0.217 million	$0.138 million	$0.3 million

As the preceding example demonstrates, CECL requires an entity to incorporate reasonable and supportable forecasts of future conditions in its reserving process. CECL also requires entities to record an allowance against current or not yet past due receivables if an entity estimates expected credit losses. For example, under Topic 606, an entity may conclude – based on its typical credit check procedures – that collection is probable from each individual customer contract and, therefore, recognize revenue and a trade receivable for the entire contract price. However, the entity's historical experience with a portfolio of customer contracts may indicate that, on average, the entity will only collect 97% of the amounts invoiced. In such circumstances, even though the entity records revenue at the full contract amount (under Topic 606), the entity will most likely need to record an allowance for bad debt against the receivable to reflect the risk of loss, even if that risk is remote.

What should I be doing to prepare for CECL?

First, take time to understand the new accounting guidance and the key differences between CECL and current GAAP. Understand how those key differences will affect your existing policies, processes, and controls. Make sure to involve parties from across the organization to best ensure all perspectives are considered.

Entities that are SEC registrants should also be mindful of the requirement in SAB Topic 11.M to disclose the expected impact of upcoming accounting changes. In particular, entities should continue to challenge whether their disclosures clearly address 1) where the entity is in its implementation process, 2) what the expected impacted to the financial statements will be, and 3) any other impacts the accounting change is expected to have on the entity's processes, policies, and controls.

Where can I get more information?

For more information about the impact of CECL, refer to Crowe's "Inside the Credit Loss Model: Requirements and Implementation Considerations" publication.

Learn more

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