ASU NO. 2016-13, FINANCIAL INSTRUMENTS – CREDIT LOSSES (TOPIC 326)

WHY IS THAT IMPORTANT?

WHAT SHOULD BE MY PLAN?

PANELISTS

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WHAT IS THE FASB UP TO?

In a change to take effect on January 1, 2020 (not that far away) 100% of *expected lifetime losses on a pool of receivables* must be reserved in the same period as originated.

SO, HOW DOES THIS AFFECT ME?

- This is just an accounting issue, right? I'm in sales, credit, collections, etc., why do I care?
  - Because your company must be ever vigilant in selecting which receivables are placed on the books!
  - Drain on Equity could be very large, especially for growing companies

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Only the most well run, well-automated, well-capitalized companies may survive

CURRENT EXPECTED CREDIT LOSS MODEL
OVERVIEW

Objective

Recognize an allowance for credit losses that results in the financial statements reflecting the net amount expected to be collected from the financial asset

Core concepts

Based on an asset's amortized cost	Reflect losses over an asset's contractual life	Consider available relevant information	Reflect the risk of loss

CURRENT EXPECTED CREDIT LOSS MODEL CORE CONCEPTS

Based on an asset's amortized cost	Reflect losses over an asset's contractual life	Consider available relevant information	Reflect the risk of loss

- Expected loss refers to the portion of a financial asset's amortized cost basis an entity does not expect to collect
- Calculation of the allowance depends on the entity's approach to measuring it:

If using a discounted cash flow approach

- The allowance should reflect the difference between the amortized cost basis and the expected cash flows discounted to a present value at the effective interest rate

If not using a discounted cash flow approach

- The allowance should reflect the expected credit losses of the amortized cost basis of the financial assets

CURRENT EXPECTED CREDIT LOSS MODEL CORE CONCEPTS

Based on an asset's amortized cost	Reflect losses over an asset's contractual life	Consider available relevant information	Reflect the risk of loss

- Expected credit losses should reflect losses that are expected over the remaining contractual life of an asset
- The life of an asset generally would not include expected extensions, renewals or modifications unless a troubled debt restructuring of the asset is reasonably expected
- Expected credit losses should reflect expected prepayments, which mitigate potential loss

CURRENT EXPECTED CREDIT LOSS MODEL CORE CONCEPTS

Based on an asset's amortized cost	Reflect losses over an asset's contractual life	Consider available relevant information	Reflect the risk of loss

- Expected credit losses should reflect reasonably available information that is relevant to the collectability of cash flows
- Specifically, entities should consider information about
  - Past events
  - Current conditions
  - Reasonable and supportable forecasts about the future
- Use information that is "reasonably available without undue cost and effort"

CURRENT EXPECTED CREDIT LOSS MODEL CORE CONCEPTS – FORECASTING

- New standard provides little application guidance on
  - How to develop a forecast
  - What the forecast should cover
- For periods in which the entity is unable to reasonably and supportably forecast expected credit losses, the entity should revert to historical credit loss information that reflects the asset's contractual term
- Reversion may be immediate, on a straight-line basis or using another rational and systematic basis

Potential economic variables
• Gross domestic product
• Inflation
• Unemployment
• Interest rate environment
• Credit spreads
• Business confidence metrics
• House price indices
• Factory orders
• Bankruptcies
• Stock market indices
• Savings rates

CURRENT EXPECTED CREDIT LOSS MODEL CORE CONCEPTS

Based on an asset's amortized cost	Reflect losses over an asset's contractual life	Consider available relevant information	Reflect the risk of loss

- Expected credit losses should include a measure of the expected risk of credit loss, even if that risk is remote
- Level of aggregation
  - Requires a collective or pool-based approach when similar risk characteristics exist
  - Allows individual approach when there are no shared risk characteristics
- An entity is not permitted to estimate a zero loss simply because the current value of the collateral exceeds the financial asset's amortized cost basis

INTERPRETATIONS AND IMPLEMENTATION ISSUES (SPRING 2018)

AICPA's Depository Institution Expert Panel
Transition resource group (TRG) Industry groups, including Big 4

FinREC Committee of the AICPA

- Reversion method: Estimation vs. accounting policy
- Zero expected credit losses

To FASB

- Transfers from HFS to HFI
- Recoveries
- Effective date for non-PBEs
- Fair value option
- Reversal of interest income
- Consideration of refinancing and prepayments
- Capitalized interest

In process (only listing a few as examples)

- Estimating life for credit card receivables
- Beneficial interest
- Discounting expected cash flows and consideration of prepayments
- Reasonable and supportable forecasting
- US vs. International auditing standards

* https://www.aicpa.org/interestareas/frc/industryinsights/credit-loss-standard-issues.html

CECL STANDARD CHALLENGES
MODELS AND METHODOLOGY

	Challenges encountered
1	**Lifetime credit losses:** Practical issues around modeling lifetime credit losses (e.g., lifetime definition, forward-looking information)
2	**Lifetime default and loss rates:** Key assumptions and limitations of the various approaches to estimate lifetime default and loss rates
3	**Validation requirements:** Ongoing validation of the key assumptions and model limitations
4	**Model creation:** For model usage, determining if models need to be created internally or purchased
5	**Reasonable and supportable:** Forecasting an appropriate reasonable and supportable period and determining mean reversion

Responses in industry

- Companies are performing model assessments to create and validate CECL-compliant models
  - Retool existing models
  - Other approaches: such as building a new model from scratch or purchasing an off-the-shelf vendor model may be used
- Institutions need to determine appropriate forecasts and create controls and governance to appropriately support forecasts for auditors
- Initial model inventory analysis and model builds should be started prior to finalizing all technical accounting policy decisions to keep the program on track
- Throughout the implementation, audit committees should be engaged with early, including checkpoints.

CECL STANDARD CHALLENGES

DATA AND IMPLEMENTATION

	Challenges encountered
1	**Data availability:** Availability of long-run historical data to support new lifetime loss models and disclosure requirements
2	**Data quality:** Reliability and accuracy of data if the data was previously not used for financial reporting
3	**Reconciliations:** Comparison and reconciliation to data currently used for allowance for loan and lease loss calculations
4	**Architecture and platforms:** Insufficient current data architecture and modelling platforms, as well as improvements required to support CECL efforts
5	**Additional data requirements:** Additional data needs for enhanced disclosures

Responses in industry

- Companies across the industry are ramping up and performing an impact assessment to mobilize and plan for CECL. Impact assessments typically include some of the following activities:
  - Completing a high-level, directional impact assessment and sensitivity analysis on financial statements to prioritize road map
  - Preparing a high-level road map and implementation plan
  - Comparing the CECL allowance to other credit loss information within the company (e.g., existing allowance)
  - Communicating financial statement impact to senior management prior to the effective date
- Most companies anticipate a multiyear implementation plan given the operational implications. Implementation activities required for implementation include:
  - Initial modelling effort underway (inventory, development, etc.)
  - Flexible approach to accommodate potential requirement changes
  - Identifying and consolidating additional internal loss and forecast data
  - Completing a dry run with CECL and current US GAAP models
  - Assessing availability of data for new disclosures, such as the new vintage disclosures

CECL STANDARD CHALLENGES
GOVERNANCE AND APPROACH

Challenges encountered	
1	**Key stakeholder buy-in:** So appropriate resources can be dedicated to the multiyear project, it is key to secure sponsorship from senior management
2	**Budget:** CECL is a multiyear implementation project requiring budget for projects across multiple areas
3	**Training:** Multiple trainings are required to inform owners and key stakeholders of changes and their involvement
4	**Expected effort:** Significant effort is required across multiple functions to adapt to standards

Responses in industry

- Defining governance structure for CECL program, including building a decision-making framework so there is consistent application of mode
- Identifying ownership of CECL program and relevant Finance Accounting Policy, and risk and IT stakeholders, as well as steering committee and project leads, considering operations, regulatory reporting, operational risk, compliance and internal audit
- Producing a target operating model with clearly defined roles and responsibilities, milestones and activities
- Staying close to industry leading practices and applying benchmarking to key areas of judgment and interpretation

IMPLEMENTATION PLAN

Project Charter

- Outlines CECL Implementation Program
- Identifies key stakeholders:
  - Risk Management, Accounting & Reporting, Treasury, Audit, Executives

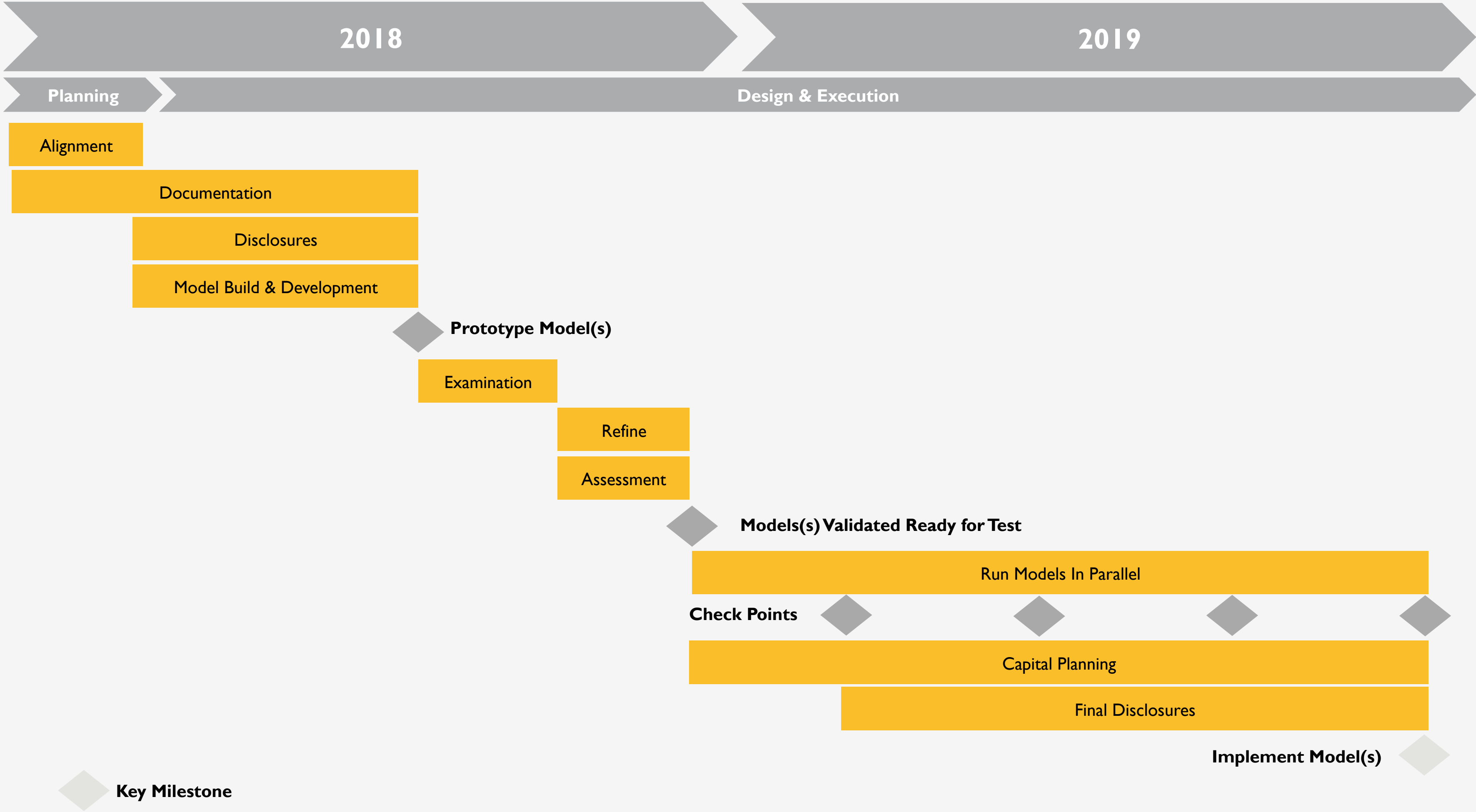
Roadmap & Timeline

- Key milestones identified

Communication

- Program status communication approach
- Periodic dashboard reporting
- Full executive briefing

CECL ROADMAP



KEY CONSIDERATIONS

Reasonable & Supportable Forecast

- The R&S forecast horizon will be defined as the contractual life of the receivables and will not be adjusted as economic conditions change

Application of Economic Forecast

- There is flexibility to utilize a quantitative economic modeling approach (i.e., driving the forecast through model inputs), or apply qualitative adjustments outside the model
  - In either case, the company must be able to articulate what the credit drivers are, and how the outlook for the drivers influences the forecast
- It is reasonable, and best practice, to maintain separate models since there are benefits/limitations to each
  - Define a "champion" or "primary" model, and use the other(s) as a checkpoint/guidepost
  - In a benign environment the forecasts should be similar; challenge will be when they diverge
- Use of scenarios is not required but is considered a best practice
  - Many companies are considering multiple scenarios to inform management decisions, rather than booking the allowance (multiple scenarios can be difficult to disclose)

Key Inputs

- Internal vintage origination and performance data, industry data from Equifax Credit Trends and JD Power PIN, Moody's macroeconomic scenarios, various macroeconomic variables